APRIL 1959

VOL. XXIX NO. 4

Reviewing the System of Internal Audit

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The Election of Corporations to be Taxed as Partnerships

Advantages and Disadvantages

•

Contingencies

•

Significant Federal Tax Decisions of 1958

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Regular Departments

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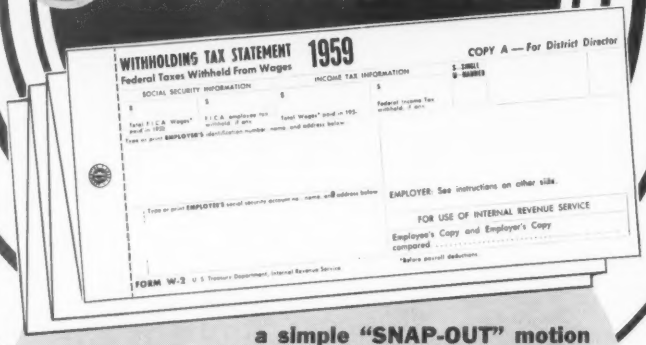


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The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

Accounting News And Trends

Statement Presentation and Subchapter S

Subchapter S, which was added to Chapter 1 of the Internal Revenue Code by the Technical Amendments Act of 1958, has raised some accounting problems. This, of course, is the Subchapter which allows certain corporations with no more than 10 shareholders to elect not to be subject to the corporate income tax, but instead to have each stockholder include his proportionate share of the taxable income of the corporation in his individual income tax return. Carman G. Blough discusses certain questions on reporting and statement presentation growing out of this new law in his department "Accounting and Auditing Problems" (THE JOURNAL OF ACCOUNTANCY, February 1959) and because of the importance of the subject we quote extensively from his discussion.

1. This election by the corporation should be disclosed by a footnote which should also include a statement concerning the possibility of the termination, either voluntarily or involuntarily, of this election.

2. If there is any plan for the corporation to advance money to stockholders for them to pay their individual income taxes, disclosure should be made of the significant facts. Various possibilities exist:

(a) If dividends for this purpose have already been declared, any unpaid portion will appear as a current liability.

(b) If any dividends are declared after the close of the accounting period but before the issuance of financial statements, disclosure should be made under the general principle of reporting significant post-balance-sheet events.

(c) Any personal advances to individual stockholders would appear as receivables of the corporation.

(d) If there is evidence that amounts will be withdrawn by stockholders, this should be reported in a footnote.

(e) If there is no definite plan for distribution to stockholders, the footnote should state that no effect has been given to amounts which may be advanced or paid as dividends to stockholders to aid them in paying their income taxes.

(f) The general rule is that the CPA should seek information about any plans to make such advances and should be sure that there has been adequate disclosure of significant facts.

3. In the case of comparative statements, the data should be presented in such a way that the possibility of misinterpretation is kept to a minimum. Comparative income statements should clearly show the amount of net income before deducting federal income taxes for the periods in which the election is not in force. In the year in which the election is effective the amount of federal income taxes which the corporation would have paid should be shown in a footnote or parenthetically. This would also be necessary for all years in which the election is in effect where comparative net income or earnings-per-share

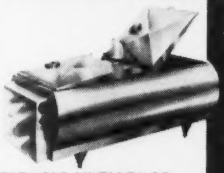
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ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, CPA. *He is presently serving as a member of our Society's Committee on Legislation.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.



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data are presented in connection with a sale of securities to the public.

4. No separation of the retained earnings on the balance sheet need be made to show the portion before and after the election or to show that portion which is taxable and nontaxable when distributed. Records should, however, be maintained so that the corporation can inform a stockholder that he has already paid the tax on certain undistributed earnings. If a stockholder sells his shares, any undistributed earnings on which he has paid a tax may be taxable again when distributed to the new stockholder. This situation could be avoided, of course, if all the corporation's taxable income is distributed in the year it is earned.

5. In the case of income tax allocation entries made in periods before the election (as, for example where accelerated depreciation has been used only for income tax purposes), Mr. Blough recommends the adjustment of the balance sheet accounts to eliminate the effect of these income tax allocation entries. Deferred or prepaid income tax accounts would be eliminated and items shown "net of taxes" would be increased to their full amount.

Another possibility (but one which Mr. Blough questions if the amounts are material) is to cancel the deferred income tax liability or prepaid tax accounts, but let the adjustments of items shown "net of taxes" work themselves out in subsequent periods as the deferred charges are amortized or the estimated liabilities are liquidated. If the effect on income taxes has been handled as an adjustment of depreciation, the undepreciated balances at the beginning of the year in which the election is made would be spread over the remaining life of the assets.

6. To aid each stockholder in computing his income tax, the corporation should inform him of the taxable income for each share. This may be different

from "earnings per share" because of certain differences between book and taxable net income. The amount may include capital gains and if so, an apportionment should be indicated between capital gains and the balance of taxable income. Similiarly, if there is a net operating loss, each stockholder's (or each share's) portion should be reported to him.

7. The corporation need not keep a record of the adjusted basis of the stock to its individual stockholders although, of course, it may do so as a convenience to its stockholders.

8. The auditor need take no exception as to consistency in the application of generally accepted accounting principles. Conditions have changed but there has been no change in the application of accounting principles.

Audit Problems and Subchapter S

As part of her comprehensive discussion in the article "Election to Have Corporation Income Taxed to Shareholders" Mary E. Lanigar (THE ARTHUR YOUNG JOURNAL January 1959) raises some interesting points with respect to the audit of such a situation. One of the questions considered is the difficulty an independent auditor may have in satisfying himself that a valid Subchapter S election is in force and that the corporation has no liability for federal income taxes.

If the auditor prepares the election forms and obtains a receipt from the District Director's office as evidence of timely filing, he is in a position to know that the election is regular on its face. Unfortunately, stock ownership problems may still disqualify the corporation. Perhaps the auditor should obtain a representation letter from each stockholder at the end of the year to be certain that an unrecorded transfer has not resulted in a termination. The audit program should also be extended to provide a review of gross receipts to ascer-

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tain that the specified items of income (dividends, interest, rents, royalties, annuities, and gains from sale of securities) do not exceed the 20-percent limit.

Opportunities in Accounting

Accountants, acting individually and through their professional organizations, have been particularly active in seeking to interest young people to enter this new and growing profession. A recent example of the efforts of one of the members of our society in this regard deserves mention.

"Opportunities in Accounting" by Raymond G. Ankers (publisher: Vocational Guidance Manuals, Inc., 1011 E. Tremont Ave., New York 60; price: $1.65) is a 118-page book that presents a comprehensive survey of the subject of accounting as a career. If you know someone who appears to have the qualifications necessary for success in the profession, you can save yourself a lot of explanations by simply placing this book in his hands. It provides, moreover, excellent reference material for guidance counselors and for speakers at career-day functions.

Glossary and Bibliography on Application of Statistical Methods to Accounting and Auditing

One of the basic difficulties facing the accountant who seeks to familiarize himself with the field of statistical sampling is a lack of understanding of the symbols and terms that are a necessary adjunct of statistical explanations. To assist in solving this problem the Committee on Statistical Sampling of the AICPA has published a "Glossary of Statistical Terms for Accountants and Bibliography on the Application of Statistical Methods to Accounting, Auditing and Management Control."

While the committee does not claim that the work is complete or even technically accurate in all its aspects, the booklet presents a useful layman's glossary and should be helpful in understanding the literature. The articles

and books suggested for reading will take the interested student a long way into the field of statistical sampling.

Readers of our magazine can take particular pride in that of the cited articles from journals and periodicals, eight of them originally appeared in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT.

Business Conditions in New York State

Accountants who wish to keep abreast of business conditions in this State should write to the Department of Commerce at 112 State St., Albany 7 and have their names placed on the mailing list for the free monthly NEW YORK STATE COMMERCE REVIEW. This 12-page magazine has two or three main articles but its summary of business statistics and the comments on "The Business Situation" would be of particular help to CPAs in discussing with clients current business conditions and future trends.

Setting the Record Straight—CPA vs. Accountant

A short item in the MICHIGAN CPA (December 1958) quoting a letter from a New York CPA to a local paper may encourage other members of the profession to take up a pen in defense of their status. The quoted letter complimented the editor on his summary of the Rotary Club plan for developing a municipal beach but objected to the phrase, "the handling of the accounts will be supervised by [Mr. .....], an accountant."

The letter sets forth briefly and forcefully the difference between a CPA and an accountant and requests that in future reporting on accountants an effort be made to use the designation *CPA* where appropriate. This effort might well inspire other members of the profession who are incorrectly described in the press.

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Letters to the Editor

Mathematical Programming

If we are to perform our function in accordance with modern trends in our profession, we must assert every reasonable effort to keep abreast with modern management techniques of which mathematical programming is rapidly becoming an important element.

If our clients have not already asked us what we know about these techniques and how they might apply to their situations, it is only a question of time. Sooner or later we will be confronted with having to express our opinion to our clients—large and small. In fact, most of us do not propose to wait until our clients raise the question. Rather, we want to gather enough information to be able to direct these new techniques and their benefits to their attention where applicable.

One other reason why we must keep informed and which is already apparent is that much of the information needed to supply management with the improved solutions which these new techniques are designed to produce is simply not available through the operation of most of our present-day accounting systems. Many thoughtful accountants believe that a new and perhaps drastically modified concept of accounting and recordkeeping may be necessary before this information does become readily available on a reliable and routine basis.

The most important immediate advantage of the mathematical approach to business problems is in the areas of inventory and production control. Where inventories get out of line to a point where substantial losses might be incurred, we usually find, as part of the underlying causes, faulty management decisions based on inadequate or misleading data.

Inventories constitute only one of many areas where mathematical techniques can be applied to great advantage. The informed auditor can recommend them for consideration in many other areas, such as distribution costs, determination of economic lot sizes in production, determination of machine loads in scheduling production, servicing of warehouses from plants to minimize freight and cartage costs, utilization of transportation facilities, and a great many others.

A high official of a large enterprise recently called attention to the rapidly growing use of these techniques and their great importance to business and industry in the future. He was severely critical of the accountants as far as the value of their function to management was concerned. He attributed the rapid growth of other groups of specialists to the failure of the accountants to up-to-date their function as it were, so as to be able to supply management with the information needed for effective control in an increasingly complex and highly competitive economy. Unless we are qualified and willing to assist our clients in the use of new and improved management tools, one of our most useful functions will be lost to others.

This does not mean for most of us that we should have to go back to school to acquire the intimate knowledge and technical proficiency of the specialist. As in the medical profession, the general practitioner is the backbone of our professional practice. We do not expect

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the general medical practitioner to be competent to perform a delicate operation, but we do expect him to recognize symptoms when we go to him for a checkup and, when needed, to place our case in the hands of a competent specialist for treatment. The regular audits which we make are not unlike the checkups for which we go to the doctor. Our clients expect from us much the same kind of service which, to my mind, is service of the highest order indeed. It is by being alert to new developments and close cooperation with one another that we can maintain and constantly increase our usefulness to American business.

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Tribulations and Triumphs of a CPA Upon Obtaining a Client in an Unfamiliar Industry

I'm sure we are not the only accountants who have ever caught a tiger by the tail or, more specifically, an account in an unfamiliar field. We thought your readers might be interested in the succession of events which ensued when, in all innocence and only slightly less ignorance, we found ourselves with a client who had just bought a resort hotel.

Fortunately, it was possible for us to be present during the actual takeover. This gave us an opportunity to learn something of the prior owner's operating problems, obtain background for subsequent allocation of the purchase price, suggest a five year noncompete agreement with the prior owner (the price of which could be depreciated over the five years), guide to some extent the valuation placed upon depreciable items and keep to a minimum the value ascribed to the intangibles.

Since it was up to us to allocate the purchase price, we supervised the inventory count closely, counting towels,

linens, soap, advertising materials, decorations, etc., until it seemed there was no end to the expendable items. As a matter of fact, there was no foreseeable end to a few of the things we found. Although the actual sale of picture post cards averaged about 1,500 we found 100,000! As a practical measure, a portion of the purchase price on over-purchased items (why would anyone buy a 50-year supply of golf pencils and gin rummy pads!) was allocated to some of the more useful supplies.

Although this part of the audit was detailed and time consuming, it was extremely necessary since only upon its completion could we be satisfied that these balance sheet items and opening entries had been reasonably established. Step followed upon step, both logically and through force of circumstance. We next confirmed receivables and payables and prepared a budget and cash flow statement.

This sounds comparatively simple, but it was not until we learned of the "uniform system of accounts for hotels" that we really began to grasp both the fundamentals and intricacies of hotel accounting. This system, begun in 1925 by hotelmen and hotel accountants, has long since become standard to the industry. We also found that a few of the larger hotel accounting firms had compiled valuable statistics over the years through the use of this system and made them available for comparison to all hotels.

Meanwhile, we were literally building from the bottom—engaging the actual accounting staff, establishing the accounting system and training the personnel to follow the system. Some of the things we found at this point hold true in almost all industries. We found all sizes and shapes of printed forms and once the pattern of record keeping had been established, we had no difficulty finding forms to fit the functions, occasionally altering one slightly to



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suit our specific needs. Bookkeeping machines were almost as many and varied, and a phone call to any of the larger companies brought all kinds, sizes and shapes of salesmen and literature.

High on our list of "things to pay special attention to" was internal accounting control—perhaps more difficult in this than in any other field. In addition to all the normal bookkeeping checks, we tried to minimize temptation by such routines as encouraging rotation of personnel on days off, having cashier's banks counted daily and cash deposited regularly, making sure the bonding policy was more than just adequate and covering more employees under the policy than, at first glance, might seem necessary. We also absorbed those bookkeeping ideas which are peculiar to the hotel industry.

We found, for instance, that the guest cards are, in a sense, the original books of entry. Postings for room charges and other credits are made directly—and frequently—to the guest card so that the status of each guest is always up-to-date and ready for check-out. The night auditor recaps and reconciles the guest accounts into a summary called the "daily transcript ledger" and this is then incorporated into a cash receipts and income journal maintained by the bookkeeper who, in turn, adds other items or collections which come directly to his office. The bookkeeper generally maintains an accounts receivable record called the City Ledger which is more permanent in nature and which covers the receivables of those who are not in the guest accounts receivable file.

The handling of some items in resort hotel accounting are also worth mentioning separately. Prior to the opening of the operating season, normal running expenses are incurred and deferred into an account called "pre-opening expenses." Likewise, after the operating season, other normal expenses are incurred and these are accrued into an account called "post-closing expenses." Both of these expenses are incorporated by proration into the operating months to reflect a more accurate picture of the profit during the active month.

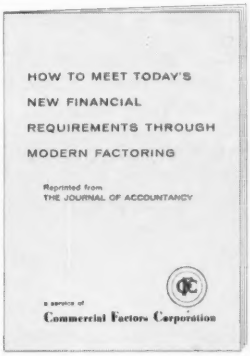
As the flurry and fluster of the opening dissipated, we began digging into other areas. Monthly audits (with a comparison to the budget) provided a constant flow of information to management. Statements were prepared on the basis of the uniform system of accounting with only moderate changes to meet the particular needs of our client but—and we felt this was important—changes were never so drastic that the published comparative statistics could not be used.

The necessity of a fairly flexible budget soon became apparent and emphasized the fact that no budget should be allowed to become so stale it is useless.

Many other facts concerning the hotel industry soon became apparent and we spent a good deal of time reading, researching, and learning. We became aware of the industry's constant need of capital for expansion and improvements; the necessity to maintain cordial relations with potential credit sources and to keep current creditors adequately informed; the highly important item of food and liquor control required intensive study in itself; the significance of insurance coverage because of the particular vulnerability of hotels (it is a good idea to have this area surveyed by an expert).

I am sure Ralph Waldo Emerson did not know how neatly he summed up this area of accounting when he said "Skill to do comes of doing!"

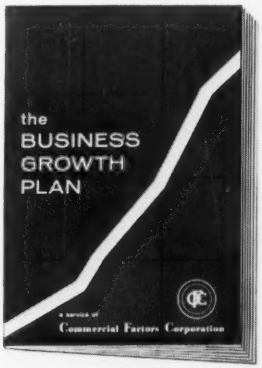
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Not long ago, a special analysis appeared in the Journal of Accountancy which created considerable interest. Its title was, "How to Meet Today's New Financial Requirements Through Modern Factoring." Its subject is especially applicable today, as businessmen prepare financially for the coming upswing in the economy.

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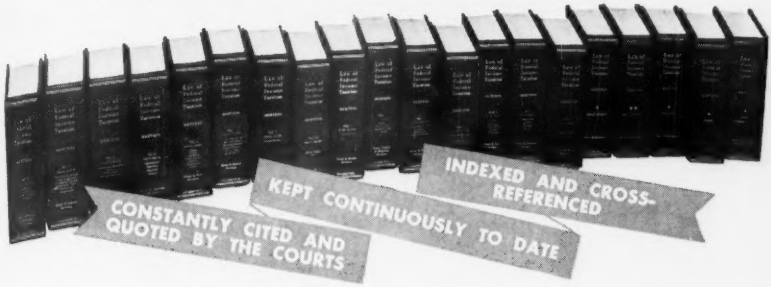
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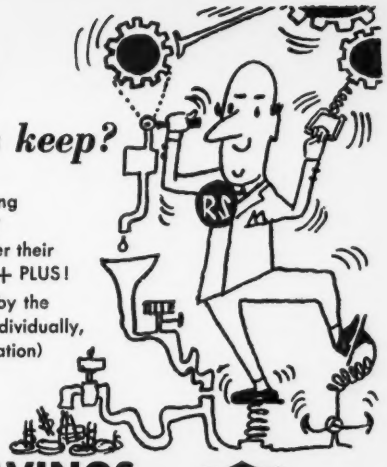
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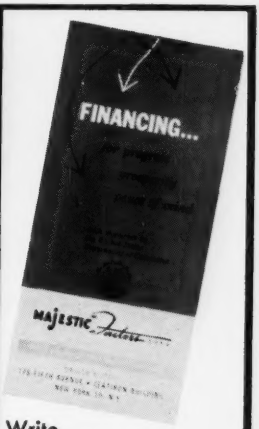
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Reviewing the System of Internal Audit

By FRANK H. TIEDEMANN, CPA

The author discusses the public accountant's responsibility to carefully evaluate the system of internal audit in order to determine the extent to which he may rely thereon and consequently reduce the scope of his own examination.

Both the public accountant and his client are interested in determining the extent to which the work of the former may be influenced by the existence of a system of audit within the client's organization. Since business management naturally strives to obtain effective audit service at the lowest possible cost, it is understandable that if a system of internal audit has been established management wants assurance that the system is operating effectively and efficiently, and that the public accountant is relying on the work of the internal auditors as much as possible.

The public accountant should be concerned with the system of internal audit for two reasons. First, the scope of his audit (and possibly the efficiency with which he conducts it), particularly in large organizations having operations at several locations, will be affected by the manner in which he takes advantage of the work done by the internal audit staff. Secondly, he has a responsibility, if he is to render maximum service to his client, to point out weaknesses in the system of internal audit and to make recommendations for improvement.

Authority for the Public Accountant to Rely on Internal Audit

Most examinations of large and medium-sized organizations by public accountants culminate in rendering a standard short-form report which states that the "examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances." It has been well established that the application of auditing standards requires a review of the circumstances found in each engagement before deciding upon the nature and extent of auditing procedures to be applied. The review and tests of the system of internal control are of particular importance to the public accountant[1] and the system of internal audit has long been recognized as a part of the system of internal control[2].

FRANK H. TIEDEMANN, CPA, *is a member of our Society's Committee on Textile Accounting and the Committee on Auditing and Accounting Procedure (Nassau-Suffolk Chapter). Mr. Tiedemann is a principal with the firm of Haskins & Sells, Certified Public Accountants.*

1. See "Statement on Auditing Procedure No. 29," American Institute of Certified Public Accountants, 1958; and "Codification of Statements on Auditing Procedure," AICPA, 1951.
2. See "Accounting Series Release No. 21," Securities and Exchange Commission, 1941.

The extent of the public accountant's work can be reduced in two ways as a direct result of the existence of an effective internal audit system. One way in which this may be done is by having certain auditing procedures carried out jointly by the internal auditor and the public accountant, thereby reducing the public accountant's time to the extent that the internal auditor participates in the work. Much has been written on the subject of joint audits and it is not our purpose to explore that subject here. We are rather concerned here with the extent to which the work of the public accountant can be reduced as a direct result of his reliance upon the work of the internal auditor insofar as it constitutes a part of the system of internal control.

Function of Internal Auditing in the System of Internal Control

A good system of internal control includes several types of controls, all of which are important. Accounting controls, budgetary controls, physical controls, and operating controls are all just as important as internal auditing. However, internal auditing is unique in that it functions by measuring and evaluating the effectiveness of other controls[3]. Although the scope of the internal auditor's work is sometimes quite broad, including such responsibilities as appraising the efficiency of clerical operations and reporting on the housekeeping in plants and warehouses, his principal objective should always be the policing of the system of internal control.

Evaluation of the system of internal audit, in common with the evaluation of other aspects of internal control, must be done carefully and systematically. Generally, the evaluation process may be divided into two phases. The public accountant must first determine that the system has been designed to provide the desired control. This may be done at the beginning of the examination. Having determined that the system has been well planned, he must then satisfy himself, by observation throughout the course of his work, that the internal audit system is functioning according to plan and that it is an effective part of the system of internal control.

Requisites for Effective Internal Auditing

Effective internal auditing depends on many things. The internal auditor and his staff must be suited by training and temperament for their work. Audit programs must be well planned and executed. Reports must be clear and conclusive, and criticisms contained therein should be followed up promptly by management to insure that corrective action is taken. Finally, the internal auditor must report to a highly placed official and enjoy the support of management generally. Only if these conditions are met can the public accountant rely on internal audit and consequently reduce the scope of his own examination.

If the public accountant is to rely on the internal auditor's work, he must have confidence in the internal auditor. A first step in the appraisal process should therefore be to learn the qualifications of the internal auditor.

The internal auditor must not only have a knowledge of accounting and auditing techniques, but must also have a clear understanding of management's responsibility for the company's operations and the stewardship of its assets.

3. "Statement of Responsibilities of the Internal Auditor," Institute of Internal Auditors, 1957.

In short, he must share management's viewpoint in his approach to his job. He must have imagination and perseverance in order to appreciate fully the significance of his findings and to follow them through to fitting conclusions. Finally, he must have the type of personality which inspires the confidence and support of management and the cooperation of executives and other employees whom he meets during the course of his examination.

The public accountant can determine whether the internal auditor has these qualifications, first, by inquiry as to his training and previous experience; secondly, through his contacts with the internal auditor during the course of his work; and finally, through his association with others who come into contact with the internal auditor and who are affected by his work.

The Internal Audit Program

The internal audit program should be reviewed by the public accountant. Although an initial review at the beginning of the engagement should disclose obvious shortcomings, the public accountant cannot conclusively determine the adequacy of the internal auditor's program until he has had an opportunity to study it in detail and relate its scope to the over-all system of internal control. The latter process must be continuous throughout the examination, inasmuch as the appraisal of the effectiveness of the system of internal control as a whole must be based upon tests carried out by the public accountant throughout the course of his work.

Internal Audit Reports

The most recent internal audit reports, including all relating to the period under review by the public accountant, should be read at the beginning of the examination (or as soon as they become available) with two purposes in mind. First, the public accountant must be concerned with the observations made by the internal auditor, since they may directly affect his own examination and possibly the financial statements. Secondly, and perhaps of even more importance, he is concerned with the manner in which the internal audit reports have been prepared, their distribution, and action taken by management as a result.

In one engagement it was arranged to have the internal audit staff cooperate with the public accountant in various phases of accounts receivable and inventory verification. The internal auditor also conducted various tests of transactions in accordance with a program recommended by the public accountant.

Although the public accountant was satisfied, based on a review of the internal auditor's work papers and other observations, that the work had been done, no formal reports were rendered. Weaknesses and errors had been disclosed by the internal auditor, but how could the public accountant in this case be satisfied that the observations had been brought to the attention of the proper persons? Furthermore, how could he be satisfied that effective follow-up action was taken to insure that unsatisfactory situations would be corrected before the year-end?

Tests of Transactions

Since the internal auditor is concerned with the control over the day-to-day transactions of his company, it is natural that tests of transactions (receipts, disbursements, sales, payrolls, etc.) account for a substantial portion of his audit program. His tests should be designed to ascertain not only that the company's instructions are being

followed in every respect in the handling and recording of the various transactions, but also that the application of the prescribed procedures has resulted in good internal control. His reports should point out instances in which required approvals were not obtained for expenditures, payroll changes, capital projects, etc. They should also report errors in recording transactions. If the system itself does not provide proper control over a particular type of transaction, that too should be brought out in the internal auditor's report. Finally, the follow-up of the comments and recommendations made by the internal auditor should be such that there is assurance to all concerned that no unsatisfactory condition will be allowed to exist for any length of time.

A critical review of the internal auditor's programs, work papers, and reports should enable the public accountant to determine whether the internal audit system has resulted in bringing to management's attention violations of directives, deviations from prescribed policies, or weaknesses in the general control over transactions. The public accountant must ascertain whether the internal auditor, in planning his tests, has given due consideration to the nature of the business, seasonal fluctuations, changes in personnel, and changes in the accounting system.

Consider, for instance, whether the internal auditor's tests were effective in this case. The company in question uses an agricultural product in its business, and must purchase a year's requirements during a relatively short harvest period. The departments responsible for purchases are naturally very busy during this period and relatively slack during the rest of the year. For years the internal auditor visited these departments only during the slack season and confined his tests to current months, principally because this arrangement was convenient to the department heads.

The public accountant, in conducting a test, discovered that the records supporting purchases made during the short busy season were much less satisfactory than those applicable to the rest of the year. This was principally because during the busy season it was necessary to hire temporary help who were much less efficient than the regular staff who did all the record keeping and processing of documents at other times.

In planning his tests of transactions, did the internal auditor in this case demonstrate the auditing know-how and imagination which is so necessary to make internal auditing effective?

Follow-up Procedures

In order to ascertain whether action is being taken to correct unsatisfactory conditions brought to management's attention by the internal auditor, the public accountant must review follow-up correspondence. He should first see that violations of prescribed procedures or instances of poor record keeping noted in the internal audit reports are brought to the attention of department heads, division comptrollers, plant managers, or others directly responsible, by the comptroller, treasurer, vice president, or someone on a comparable level of management. Usually a copy of the internal audit report should be available to the head of the division or plant covered by the report.

The second step in reviewing the effectiveness of follow-up procedures is to determine whether the persons responsible for the divisions or plants covered by the internal audit reports are required to reply promptly to the internal auditor's criticisms, either describing the action taken or to be taken to correct the conditions noted, or

refuting the auditor's observations or recommendations.

The third phase of the follow-up process is to ascertain by subsequent observation that unsatisfactory conditions have been corrected. The public accountant is in an excellent position, during the course of his preliminary or year-end work, to see whether corrective action has been taken. If the internal auditor's recommendations have been disputed by the local or departmental management, the public accountant should determine whether the dispute has been resolved by higher management and whether any action decided upon by such higher management has been taken. Although some of the internal auditor's recommendations may relate to economy, safety, or policy matters not having a direct relationship to internal control, the public accountant must satisfy himself in all cases that implementation of the internal auditor's recommendations has not resulted in a weakening of internal control.

If the public accountant sees that the internal auditor's tests of transactions, his reporting thereon, and follow-up procedures are as described above, he certainly should be able to minimize his own tests. Obviously, the public accountant must satisfy himself through personal observation that the system is designed to provide adequate controls, and for this purpose he must carry out some tests. However, his tests need not be as extensive as would be required if he had to rely only on his own tests to determine whether in practice the system is functioning according to plan.

If he is able to satisfy himself that the internal auditor's work is effective in insuring that good controls over transactions are being maintained, the public accountant is completely justified in relying on the latter in this area. In the case of a client with operations at several locations, this means not only that the public accountant's tests at a given location may be reduced, but he may also be able to reduce the number of locations at which he conducts tests during any one year. For instance, the public accountant may visit certain locations once in every three or four years, depending on the significance of the operations of those locations in relation to the company as a whole, relying on the internal auditor's work in the interim years. It may also be appropriate for the public accountant to eliminate certain tests of transactions from his program at some locations, even though he is present at those same locations for other purposes, such as accounts receivable or inventory verification.

Inventories

The internal auditor, because of his intimate knowledge of his company's affairs, is in an excellent position to appraise inventory controls. The public accountant should determine whether the internal auditor has given attention not only to internal checks inherent in the bookkeeping system, the accuracy of perpetual inventory records and the manner in which physical counts are conducted, but also to the contribution to good inventory control made by a standard cost system, factory controls, and warehousing methods.

A review of the internal auditor's programs and reports should disclose whether the internal auditor's examination of inventory controls and records has been sufficiently broad. His program should include sufficient tests, including physical counts, to determine the accuracy of the records. Significant differences between quantities shown in the inventory records and quantities physically counted should be noted in the internal auditor's reports, and the follow-up procedure should require ex-

planations from those responsible. Explanations obtainable during the course of the internal auditor's examination may be included in his report.

If the public accountant concludes that the internal auditor's review of inventory controls is effective, he should be able to reduce his own inventory tests considerably. As to physical observation, the public accountant must make sufficient observations to be completely satisfied that the physical counts are so planned and conducted that they should result in a proper tabulation of inventory owned at the verification date. However, if he has confidence in the effectiveness of the internal audit system in insuring that prescribed procedures are followed, the public accountant may rely on the internal auditor for much of the routine audit procedure, such as checking count tags to tabulations, verifying descriptions, and accounting for tag numbers, thereby limiting considerably his own tests in these areas. Furthermore, he may be able to rely completely on the internal auditor with respect to certain segments of the inventory. For instance, he may be willing to rely on internal audit with respect to some types of supplies inventories, or he may be willing to visit certain locations only every other year for the purpose of physical observation, relying on the internal auditor's examination in the interim years.

Accounts Receivable

In reviewing the internal auditor's work in connection with accounts receivable, the public accountant must satisfy himself, by reviewing the internal auditor's programs, papers, and reports, that the internal audit has been directed to determining that adequate controls are being maintained over accounts receivable and that, as a result, the balances carried in the accounts, after deducting allowances for doubtful accounts and returns, may reasonably be expected to be collected.

The public accountant must see that the internal auditor's program provides for adequate tests to determine the accuracy of the records. Such tests would include checking of entries to supporting documents—invoices, credit memoranda, and cash receipts. If the public accountant is satisfied that the internal auditor has carried out adequate tests, that his findings have been properly reported, and that any action required to correct errors or strengthen controls over accounts receivable has been taken, the public accountant's tests, except for confirmation with debtors, may be reduced to the minimum required to satisfy himself that the controls over accounts receivable have been well established. He can rely upon the internal auditor to ascertain that they are well maintained.

Because the public accountant is required, in accordance with generally accepted auditing standards, to independently confirm accounts receivable, he is limited as to the extent to which he may rely upon the internal auditor's work in this area. However, the following may well be done by the internal audit staff to a large extent, subject to review and test by the public accountant:

1. Preparation of confirmation forms.
2. Follow-up of exceptions, including ascertaining that required adjustments are made.
3. Tabulation of confirmation statistics.

With respect to the allowance for doubtful accounts, the public accountant must satisfy himself by personal observation that the system established for estimating losses is adequate. But if he is satisfied that there has been an adequate internal audit of this account

he should be able to limit his own review to a consideration of the reasonableness of the reserve in the light of the condition of the receivables as indicated by the aged trial balance and the internal auditor's observations. He should be able to rely considerably on the internal auditor's tests of source data (credit reports, etc.) and calculations.

Cash

If the internal auditor includes in his program a periodic verification of cash there is no reason why the public accountant cannot rely to some extent on this verification and accordingly limit his own examination of cash balances. He may limit his examination either by restricting his verification to large balances and only a portion of the remaining cash balances at any one date, or he may be able to restrict the extent of his verification procedures with respect to certain cash balances. For instance, it may be appropriate for the public accountant to accept a cash reconcilement verified by the internal auditor but conduct himself a cut-off check, preferably by obtaining subsequent bank statements directly from the depositaries. In circumstances where the public accountant has accepted reconcilements prepared by the internal auditor, he should of course review such reconcilements critically to satisfy himself that they have been prepared in accordance with acceptable auditing standards.

Prepaid Expenses

Many hours of audit time can be spent in verifying the mathematical computations of prepaid expenses, such as insurance and interest. If the internal auditor has reviewed such accounts during the course of the year, particularly if this verification has been done as of a date late in the year, the public accountant should be able to reduce the extent of his own tests. In some cases it may be appropriate for the public accountant to confine his work to a review of changes in the accounts during the period under review, relying entirely on the internal auditor's tests of the details. The public accountant would of course have to satisfy himself through appropriate tests and review of the internal auditor's work papers that the latter's work had been satisfactorily done.

Accrued Liabilities

Accrued liabilities may also require considerable time to verify. For example, the verification of accrued taxes may require the review of many tax bills and a check of a considerable number of calculations. The verification of this account may be done periodically by the internal auditor. If the public accountant is able to satisfy himself that the internal auditor has carried out an adequate test of accrued taxes, he would probably be able to limit his own examination to a consideration of any significant changes during the year and a review of the procedures followed. Similarly, if the internal auditor has made adequate tests with respect to the recording of interest payable, including verification of interest rates and computation of the amounts accrued by reference to the last interest payment date, the public accountant should be able to rely upon the internal auditor's verification of the record keeping and confine his own examination to such tests as he considers necessary in connection with his review of the system.

Improving the System

The public accountant should not be satisfied with merely determining the extent to which he can rely on the sys-

tem of internal audit and then planning his own work accordingly. Internal audit, like other internal controls, is always subject to improvement. The public accountant who points out to his client weaknesses noted, no matter how minor they seem, is performing a valuable service. He should therefore be alert at all times to the possibility of improving the effectiveness of internal audit. Consider, for instance, the following situation.

Company *X* produces a considerable amount of fairly valuable scrap in the course of manufacture. Because of its volume and value, the company contracts on a company-wide basis for the sale of scrap at the best possible price. Plants are prohibited from selling scrap to anyone other than the party designated by the head office unless specific approval is obtained.

The internal audit program provides for a test of scrap sales to ascertain that the head office directive is being observed. The public accountant, in reviewing an internal audit report relating to one plant, noted that sales of scrap were made locally without the required approval.

This violation of procedure, which is extremely rare in this company, was duly reported as required. However, because of the nature of the scrap, it would have been simple for the person responsible for the handling of scrap at this plant to arrange a kick-back in connection with such sales, had he been so inclined. Yet the internal auditor made no effort to explore this possibility. This could have been done by comparing the sales price obtained locally with that stipulated in the contract negotiated by the head office, and by a more thorough examination of documents, including a check of weights paid for with weights produced according to production department records.

In this case there can be no disputing the fact that the internal auditor was effective in bringing to management's attention the violation of its directive. However, could not internal audit have been even more effective if the internal auditor had seen the possibility of irregularities indicated by this violation of a directive? Furthermore, if the public accountant had any reservations as to the internal auditor's ability to recognize a possible irregularity in the sale of scrap, could he feel completely confident as to the internal auditor's effectiveness in other areas?

In addition to pointing out such weaknesses so that they may be corrected, the public accountant can also help in setting up internal audit programs or drafting the format of internal audit reports or follow-up correspondence. He, as well as his client, will benefit during the course of subsequent audits.

It is possible that a client which has no internal audit system should have one. The public accountant who is alert to this possibility and is instrumental in the establishment of an effective system of internal audit may well find that, because of the benefits derived therefrom by management, he has opened the door to more extensive service to his client in the area of management advice.

Conclusion

The public accountant views the system of internal audit as that part of the system of internal control which concerns itself with (a) the evaluation of the internal controls established by management, and (b) the policing of the system to see that such controls are being properly maintained. The effectiveness of internal auditing will depend both upon a clear understanding of its objectives by the internal auditor and his

staff and upon well-planned, directed, and executed programs. If these conditions are present, and management takes full advantage of the benefits to be received from such a system, improvement in the system of internal control will undoubtedly result. It then follows that the public accountant will be able to rely to a greater extent on the company's internal controls (including internal audit), and consequently restrict his own audit procedures to a minimum compatible with accepted auditing standards.

The public accountant has a responsibility to his client to rely upon the system of internal audit as much as possible. But determining the extent to which he can do so requires a careful appraisal of the system. It is not the mechanics of the internal auditor's test of vouchers, payrolls, and postings that is the basis of reducing the public accountant's scope. He cannot automatically examine one less voucher for every one the internal auditor checks. Reductions in the scope of the public accountant's program made in reliance upon the system of internal audit are possible only when the public accountant is able to recognize the internal audit system as an effective part of the system of internal control.

The Operational Audit

Many auditors, especially those trained primarily in financial auditing, feel somewhat at sea when assigned to an operational audit. In such instances, a safe lifeline back to financial auditing matters may be helpful. For instance, it would be a gross mistake for an auditor wanting to review the operations of the final assembly department to walk up to the manager of that department and say, "I am now going to audit your assembly process to see if it is properly managed." Such an approach would almost immediately close the door to that fine degree of cooperation which is needed from the manager or department head. A natural entry would be through an audit of payrolls, which leads to incentive pay, which leads to the supporting time studies, and the auditor is then deep into the operations of the assembly department. Or, if there is no incentive pay system, the audit of vouchers payable would lead into the audit of materials vouchers, which leads to bills of materials or materials requisitions, and the auditor finds himself back in the assembly department again.

ROBERT E. SEILER, "The Operational Audit,"
THE INTERNAL AUDITOR, March 1959

The Election of Corporations to be Taxed as Partnerships — Advantages and Disadvantages

By NATHAN EIDENBERG, CPA

In the December 1958 issue of THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT the writer analyzed the basic provisions of Subchapter S in the article entitled "The Election of Corporations to be Taxed as Partnerships." The purpose of the present article is to examine certain areas in which the new provisions may prove advantageous and to indicate some of the pitfalls.

Subchapter S falls into the category of "relief" provisions—those designed to lighten the tax burden. Little wonder that it has attracted so much interest. While there is no inclination to look this gift horse in the mouth, there is a natural wariness on the part of taxpayers before embarking upon these unchartered waters.

According to the Senate Committee Report on the Technical Amendments Act of 1958, Subchapter S was enacted as an aid to "small business." The legislation however does not limit its provisions to corporations of any particular size except that the limitation on the number of stockholders (they may not exceed ten in number) effectively eliminates so-called "big business." This still leaves the provisions available to many corporations of very substantial size which have no more than ten stockholders. It is unlikely, however, that such companies would avail themselves of the election because their probable high incomes would be taxed at higher rates in the hands of the stockholders than at the 52-percent corporate rate. Likewise, a small corporation would not elect if it means adding even a moderate amount of corporate income to already substantial income of its stockholders. The foregoing comments do not apply to eligible corporations which pay out substantially all of their net income as dividends. In such cases an election is bound to be beneficial since the corporate tax is avoided. On the other hand, if an eligible corporation loses money, the higher the income of the stockholders, the greater the benefit in electing the provisions of Subchapter S.

Since corporations normally operate at a profit and retain a substantial portion of such profit, the new provisions will typically apply to small corporations whose stockholders have moderate incomes with the result that the income of the corporation will be subject to a lighter tax in their hands than in that of the corporation. Thus, the Congressional intent of aiding small business is made apparent.

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Nevertheless, somewhat like miracle drugs with their side effects, the new provisions do seem to lend themselves to situations which were probably not in the Congressional mind. The following example, although of limited application to taxpayers generally, illustrates this type of situation.

Smith is a wealthy individual. He owns all of the stock of Corporation *X*. The corporation is engaged in a trade or business which loses about $100,000 a year. The corporation also is engaged in a separate manufacturing business which results in an annual profit of some $125,000. The profitable business was acquired by purchase by Corporation *X*. Under Section 270 of the Code, if the first trade or business were carried on by Smith, individually, and lost over $50,000 for each of five consecutive years, the annual losses in excess of $50,000 would be disallowed as a deduction to Smith.

As a result of the enactment of Subchapter S, Corporation *X* elects the provisions of that subchapter for the calendar year 1959. During 1959 the corporation sells the assets of the profitable business at a gain, a substantial part of which is long-term capital gain attributable to the fixed assets. The following summarizes the results for the year 1959:

Net long-term capital gain		$250,000
Net profit from manufacturing business including sale of inventory..	$125,000	
Less loss on retained trade or business	100,000	25,000
Taxable income		$275,000

Under Section 1375, Smith would include the corporate long-term capital gain of $250,000, as such, in his hands, and the remaining $25,000 as ordinary income. In addition, the corporation could distribute the $275,000 to Smith.

At this point Corporation *X* continues the operation of its remaining trade or business, retaining its status as an electing corporation. The losses of the corporation attributable to such trade or business would be deductible by Smith under Subchapter S (Section 1374). The limitation under Section 270, on the amount of losses deductible by Smith from this trade or business is applicable only where the trade or business is carried on by him. In this case the trade or business is carried on by Corporation *X* which is a separate corporate entity.

This is not a case where the corporation was formed to obtain the advantages peculiar to this type of situation under Subchapter S. If this were so, Section 269 dealing with corporate acquisitions to obtain the benefit of deductions, etc., not otherwise available, might apply. Here the corporation had been in existence long before the appearance of Subchapter S and, it is assumed, has passed muster as a separate taxable entity. It would seem unlikely that the corporation could be disregarded and the trade or business considered as carried on by the stockholder for the purpose of applying the provisions of Section 270. It is fundamental that an electing corporation is nonetheless a corporation, retaining its separate identity despite the fact that it ceases to be a tax-paying entity.

Acquisitions for Purposes of Tax Avoidance

Taxpayers should not lose sight of Section 269 when considering the use of Subchapter S under certain circumstances. The predecessor of Section 269 (Section 129 of the 1939 Code) was enacted in 1943. It authorizes the Commissioner to disallow a deduction, credit or allowance not otherwise available, in

cases where control of a corporation is acquired principally for the purpose of tax evasion or avoidance. Suppose an existing corporation owns substantial fixed assets which have a tax basis far in excess of their fair market value. All of the stock of the corporation is purchased by an individual whose personal income is subjected to high tax rates. The new stockholder causes the corporation to elect under Subchapter S for succeeding taxable years. The corporation then proceeds to sell off some of its high basis fixed assets resulting in losses which qualify as ordinary deductions under Section 1231 of the Code. These losses far exceed the other corporate income so that the corporation sustains net operating losses. The stockholder then proceeds to claim these net operating losses as deductions against his other income. His cost of the stock is assumed to be in excess of the claimed losses.

In this type of situation where the price paid for the stock is substantially less than its book value, that fact is considered as prima-facie evidence of the principal purpose of evasion or avoidance of federal income tax. (Section 269(c), I.R.C.) This does not create a conclusive determination of the prohibited purpose, but it does place on the taxpayer the burden of proving that tax considerations were not the principal purpose for the acquisition. The argument that the taxpayer is merely availing himself of a newly enacted relief provision hardly seems persuasive in the light of Section 269.

A somewhat similar conflict was resolved in the favor of taxpayers in connection with the provisions granting relief to Western Hemisphere Trade Corporations. (Section 921 of the 1954 Code; successor to Section 109 of the 1939 Code.) Here the Commissioner ruled that the acquisition (formation) of a corporation to qualify for the benefits accorded to Western Hemisphere Trade Corporations would not run afoul of Section 269. The rationale here was that the basic Congressional purpose was to favor corporations doing business to a substantial degree in certain foreign countries. (I.T. 3757, 1945 CB 200.)

However, it should be pointed out that in the case of the Western Hemisphere Trade Corporation ruling, the Commissioner recognized that the formation of a corporation to obtain the benefits which Congress plainly intended, should not be nullified by Section 269. Thus, it is reasonably plain that the Commissioner would not raise Section 269 to defeat the attempt to incorporate a business to obtain the *intended* benefits of Subchapter S.

The Collapsible Corporation and Subchapter S

A group of five individuals own all the stock of a corporation which they organized 18 months ago. The corporation acquired for investment a single piece of real property which it has been operating. A very attractive offer is received for the property. The stockholders would like to effect the sale, but at a single capital gains tax. The corporation is "collapsible" within the meaning of Section 341 so that the sale of the stock at a gain would result in ordinary income. As a collapsible corporation the use of Section 337 is not available as a means of achieving a single capital gains tax. If the corporation were to sell the property and then liquidate, two capital gains taxes would be incurred; one to the corporation and another to the stockholders upon liquidation.

The question arises whether this corporation could achieve the single capital gains objective by invoking the provision of Subchapter S. Under that subchapter, the corporation would sell the property,

a Section 1231 asset, and the resulting long-term capital gain would be taxable as such in the hands of the stockholders. Thus would the single capital gains tax objective be realized.

As to the basic question, i.e., whether a collapsible corporation is eligible to elect the provisions of Subchapter S, assuming it is otherwise qualified, there is nothing in Subchapter S which denies its provisions to a collapsible corporation. On the other hand, the provisions of certain other sections of the Code do specifically bar collapsible corporations from their use. Thus, Section 337, under which a corporation can sell its property and liquidate completely within 12 months, all at a single tax at the stockholder level, is not available to a collapsible corporation. (Section 337(c).) A collapsible corporation is likewise ineligible to participate in a "one month" liquidation under Section 333 of the Code. (Section 333(a).) Section 112(b)(7) of the 1939 Code, the corresponding section of present Section 333, contained no similar bar to collapsible corporations, and the Commissioner ruled that a collapsible corporation could avail itself of the provisions of Section 112(b)(7).

In the light of the foregoing it would appear that a collapsible corporation could elect the provisions of Subchapter S, if it is otherwise eligible.

Risk of Termination Because of Ineligible Income

The fact that, in the example under discussion, the corporation's principal asset consists of a piece of rental property may present other problems bearing upon the use of Subchapter S. Under Section 1372(e)(5) an election is terminated for any taxable year during which more than 20 percent of the corporation's gross receipts consists of rents, interest, etc. Such a termination would prevent the corporation from making another election for five taxable years, unless the Commissioner, upon application, grants an earlier election. It is important therefore to so time the election that it is effective for a year during which the receipts from rents will not exceed 20 percent of total gross receipts. Where rents are substantially the only source of receipts, an election which is made for the year during which the property is sold would offer the best chance to avoid termination, since the gross receipts (selling price) from the sale of the real property does not constitute prohibited receipts. If the sale is not reported on the installment basis, the entire profit is recognized and the receipts factor is maximized. On the other hand, if the sale is reported by the corporation on the installment basis, receipts from the sale will be reduced accordingly. The following examples will illustrate the point.

Corporation *A* elects to be subject to Subchapter S for the calendar year 1959. A piece of rental property, its principal asset, is sold by the corporation on July 31, 1959. The following additional facts are assumed:

Selling price of real property:		$80,000
Represented by:		
Cash	$10,000	
Existing 1st mtge.	40,000	
Purchase money mtge.	30,000	$80,000
Corporation's tax basis of property		$50,000
Rental income to date of sale		$ 4,500
Interest on purchase money mortgage accrued during 1959		$ 625

	Gross Receipts	
	Accrual Basis of Accounting	Installment Basis of Accounting
Rent	$ 4,500	$ 4,500
"Receipt" on sale of property	80,000	20,000*
Interest	625	625
Total receipts	$85,125	$25,125
Prohibited receipts: rent and interest	$ 5,125	$ 5,125
20% of total receipts	$17,025	$ 5,025

Thus, the accrual basis of reporting the sale will qualify the receipts for the election while the use of the installment basis will result in a disqualifying receipt pattern. In the latter case, if the interest had been several hundred dollars less, the receipts would have qualified.

Upon the sale of the real property in the above example, the resulting profit constituting long-term capital gain would be computed by the corporation and taxed to the stockholders, as indicated, either on the accrual or the installment basis. It is assumed that when the total profit is computed and taxed on the accrual or installment basis, as the case may be, the electing corporation will be completely liquidated. Since the gain on the sale of the corporation's property is taxed to the stockholders, the basis of the stock in the hands of the stockholders is increased by the undistributed taxable income attributable to such stock. (Section 1376.) Thus, upon the complete liquidation of the corporation, there should be no further gain resulting from the liquidating distributions attributable to the property sold by the corporation. If the election of a corporation is terminated during one of the taxable years during which the sale of property is being computed on the installment basis, the annual installment gain would thereupon become taxable to the corporation.

The use of the installment basis is subject to the risk that a subsequent change in legislation will deny the benefits of Subchapter S as to installment gains realized after the effective date of the change.

The Non-Recurring Long-Term Capital Gain

The above discussion dealing with the application of Subchapter S to collapsible corporations illustrates the rare opportunity of withdrawing corporate funds at a single long-term capital gain. Ordinarily, corporate dividends are subject to full normal and surtaxes in the hands of individual stockholders, irrespective of the character of the corporate earnings and profits from which the dividends are paid. Thus, long-term capital gain realized by a regular corporation is transmuted into ordinary dividend income when paid out by the corporation. In addition, the corporation

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* Selling price $80,000
Basis 50,000

Gross profit $30,000

Gross profit percentage 37.5%

"Contract price":
Cash $10,000
P.M.M. 30,000 $40,000

$$\frac{\$30,000}{\$40,000} \times \$10,000 = \$7,500 \text{ (Installment gain in year of sale)}$$

$$\frac{\$7,500}{37.5\%} = \$20,000 \text{ (Receipts in year of sale)}$$

is subject to a capital gains tax. In the case of an electing corporation, however, its long-term capital gains are taxable once in the hands of the stockholders, as long-term capital gains. In addition, the amount of such gains may be withdrawn by the stockholders who reported such gains in their tax returns. This distribution is applied in reduction of the basis of the stock and thus will generally result in no immediate tax impact. It is important to remember that to receive this favorable treatment, the distribution must be made during a taxable year of the corporation for which the election under Subchapter S is effective.

A corporation expecting to realize such a long-term capital gain can elect the provisions of Subchapter S for the year of such gain, distribute its taxable income (estimated as accurately as possible) prior to the close of that year, and then revoke the election before the close of the first month of the succeeding taxable year. The election would thus be limited to the year during which the long-term gain was realized.

Consider the case of a corporation which is faced with an unexpected opportunity to effect a sale of property at a price which would yield a substantial long-term capital gain. The price is so favorable that the corporation cannot afford to turn the offer down. However, it is too late to elect for that year. To obtain the benefits of Subchapter S in this case, the selling corporation should arrange for a small down payment in the year of sale, report the sale on the installment basis, and defer the realization of most of the gain to subsequent years for which an election under Subchapter S would be made. It is assumed that such deferral would be consistent with sound business considerations.

It should be noted that the amount of long-term capital gains of an electing corporation, taxable as such to its stockholders, may not exceed the taxable income of the corporation. For example, if an electing corporation has net long-term capital gains of $40,000 and a net loss of $10,000 from regular operations, the stockholders will report the $30,000 of taxable income as long-term capital gain. Thus, the ordinary loss of $10,000 is in effect converted into a capital loss. To the extent that salaries to stockholders create an ordinary loss, to that extent the long-term capital gains will, in effect, be taxable as ordinary income. For example:

	Case A	Case B
Ordinary net income, before salaries	$25,000	$25,000
Less stockholder salaries.	10,000	35,000
Ordinary net income	$15,000	($10,000)
Long-term capital gain	40,000	40,000
Net income	$55,000	$30,000
Reportable by Stockholders:		
Salary	$10,000	$35,000
Dividend	15,000	–0–
Ordinary income	$25,000	$35,000
Long-term capital gain	40,000	30,000
Total	$65,000	$65,000

Flexibility in Allocation of Income

Prior to the 1954 Code, partnerships could choose fiscal years so as to defer the tax on partnership income. Thus, calendar year partners would form partnerships with January 31 fiscal years. Under present law this can no longer be done. A newly-formed electing corporation, however, can choose a fiscal year to suit its stockholders.

The taxable income of an electing corporation is taxable pro rata to those persons who hold the stock on the last day of the taxable year. If a high-bracket stockholder wants to relieve himself, of all or a part, of his share of an electing corporation's income, he can do so by making a bona-fide gift

of all or a part of his stock just before the close of the corporation's taxable year, providing that the donee consents to the election.

Income in Respect of a Decedent

The question has arisen whether Section 691, dealing with income in respect of a decedent, has any application to an electing corporation. A stockholder of such a corporation dies before the close of its fiscal year. His estate files a consent to the election as a new shareholder. The estate is taxable on $40,000, its share of the corporation's undistributed taxable income for its fiscal year. Of such $40,000, $25,000 was earned to the date of death and such amount is included as part of the value of the decedent's stock for estate tax purposes. If Section 691 applied, the decedent's estate would be entitled to deduct, for income tax purposes, that portion of the estate tax attributable to the inclusion of the $25,000 in the gross estate.

In the case of a true partnership, the $25,000 would be treated as income in respect of a decedent. (Section 753 I.R.C. and regulations thereunder.) On the other hand, in the case of a conventional corporation, it is equally clear that Section 691 would not apply. It has been argued that the "conventional corporation" view should prevail and that Section 691 should not apply because under Section 1373(b), the undistributed taxable income of an electing corporation "shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation." This view may be unduly narrow. A distinction of substance seems to lie in the fact that while dividends of conventional corporations may have only a fortuitous relation to the earnings of the year in which they are paid, the "constructive" dividends of electing corporations always represent the current year's undistributed income. Appropriate adjustments required for cash dividends made during the year prior to death or for non-cash distributions, should not defeat the basic analogy to the partnership distributable income concept. There is, at least, a reasonable possibility that Section 691 may have application to electing corporations.

The Problem of Minority Stockholders

When dealing with the stock of an electing corporation, special consideration must be accorded to certain peculiar characteristics of such stock. For example, the preservation of the election is dependent on the conduct of each stockholder no matter how small the holding. A minority stockholder can cause the termination of an election by putting his stock in a trust either by will or while he is alive. A sale of his stock to several purchasers may result in the number of stockholders exceeding the maximum of ten. The question has been raised whether the stockholders of an electing corporation should provide against these contingencies in a stockholders' agreement, assuming that restrictions of this character are legal in the particular jurisdiction.

Adequacy of Tax Reserves

When accountants are called upon to establish the book value of an electing corporation, it should not be lightly assumed that the corporation has no federal income tax liability. The election may have been in effect for a short time so that consideration should be given to possible tax deficiencies for prior years when there was no electing corporation status. The purchaser of the stock of an electing corporation should provide for the contingency that the election may be invalidated.

Variation in Tax Basis of Stock

Special equitable considerations arise when there is a wide variation as among stockholders in the tax basis of stock of an electing corporation. Because the basis of stock is a limiting factor on the amount of corporate losses available to the stockholders, an election may permit some stockholders to use the losses while in the case of low basis stockholders the losses are lost forever.

Stockholders' Salaries and Travel and Entertaining Expenses

Special mention should be made of travel and entertaining expenses incurred by the corporation on behalf of stockholders, and salaries of officer-stockholders. In the case of ordinary corporations, a disallowance of such travel and entertaining expenses results in additional corporate tax as well as additional income to the stockholders on whose behalf the expenses were incurred. A salary disallowance will result in an additional corporate tax.

If such disallowances occur in the case of an electing corporation, the result will depend on the character accorded these items in the hands of the stockholders. There is no corporate tax in any event. In the case of disallowed salaries there still remains the possibility of a "double" tax in the hands of the stockholders, if the amount received by the stockholders as salaries is still deemed to be salary income despite the fact that a portion is deemed to be unreasonable as far as the corporation is concerned. In this case, the stockholder would be charged with a greater corporate income in his hands as well as the salary income. For example, assume an electing corporation with taxable income of $30,000 after salaries to two equal stockholders of $25,000 and $30,000, respectively. The taxable income of each stockholder derived from the corporation will appear as follows:

	Stockholder A	Stockholder B
Salary	$25,000	$30,000
Corporate income	15,000	15,000
Total	$40,000	$45,000

Assume that $7,500 of *A's* salary is disallowed and $5,000 of *B's* salary is disallowed, resulting in revised corporate income of $42,500. If the disallowed salaries lose their character as salary income in the hands of the stockholders and are treated as dividends, the taxable income of the stockholders will appear as follows:

	Stockholder A	Stockholder B
Salary	$17,500	$25,000
Corporate Income:		
"Actual dividends"	$ 7,500	$ 5,000
Constructive dividends ..	15,000	15,000
	$22,500	$20,000
Total	$40,000	$45,000

It will be noted that on this basis the income of the stockholders is unchanged with a shift of salary income to dividend income. Under Subchapter S, neither the actual dividends nor the constructive dividends are accorded the 4 percent tax credit or the dividend exclusion.

Now suppose that the Commissioner argues that the excessive salary, although disallowed to the corporation as unreasonable, still retains its character as salary (albeit unreasonable) to the stockholders or at least does not qualify as a "dividend." If this position is upheld, the resulting income to the stockholders would be as follows:

	Stockholder A	Stockholder B
Salary	$25,000	$30,000
Corporate income	21,250	21,250
Total	$46,250	$51,250

Here the stockholders would find themselves with additional income of $12,500 being taxed both on the disallowed salary as well as on the additional corporate income in the same amount.

The same problem is present in the case of disallowed travel and entertaining expenses, with one variation. The corporation may be in a position to argue that the disallowed expenses are nevertheless deductible in arriving at the corporation's taxable income as additional compensation to the officer-stockholders involved. Taxpayers have not been successful in this contention where the recipient of the travel and entertaining expenses is practically the sole stockholder.

Let us assume an electing corporation with taxable income of $50,000 after deduction of $10,000 for travel and entertaining expenses claimed to have been incurred for its sole stockholder. Upon examination, $5,000 of these expenses are disallowed because of lack of substantiation. Here is how the stockholder would fare on the following assumed facts:

(A) The $5,000 is disallowed to the corporation and taxed to the stockholder as ordinary income, other than as a dividend.

(B) The $5,000 is disallowed to the corporation and taxed to the stockholder as a dividend from the electing corporation.

(C) The $5,000 is disallowed to the corporation as travel and entertaining expenses but is allowed instead as additional compensation to the stockholder.

The effect of these assumptions is set forth in the following tabulation:

		Case A	Case B	Case C
Corporate taxable income	$50,000	$55,000	$55,000	$50,000
Stockholder income:				
ordinary income	$ —	$ 5,000	$ —	$ —
salary income	—	—	—	5,000
corporate income	50,000	55,000	55,000	50,000
Total	$50,000	$60,000	$55,000	$55,000

Where stockholders of a closely held corporation are involved, it has generally been the practice to treat the disallowed expenses as a dividend. On this basis, the use of Subchapter S would avoid one of the two taxes that would be imposed in the case of a conventional corporation.

Official Release

Contingencies

Issued October 1958 as Accounting Research Bulletin No. 50 by the Committee on Accounting Procedure, American Institute of Certified Public Accountants.

1. In the preparation of financial statements presenting financial position or operating results, or both, it is necessary to give consideration to contingencies. In accounting a contingency is an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain or loss. A commitment which is not dependent upon some significant intervening factor or decision should not be described as a contingency.

Discussion

2. The contingencies with which this bulletin is primarily concerned are those in which the outcome is not sufficiently predictable to permit recording in the accounts, but in which there is a reasonable possibility of an outcome which might materially affect financial position or results of operations. Examples of contingencies which may result in the incurrence of liabilities, or in losses, are pending or threatened litigation, assessments or possible assessments of additional taxes, or other claims such as renegotiation refunds, that are being or would be contested, guarantees of indebtedness of others, and agreements to repurchase receivables which have been sold. Examples of contingencies which may result in the acquisition of assets, or in gains, are claims against others for patent infringement, price redetermination upward and claims for reimbursement under condemnation proceedings. Material contingencies of the types discussed in this paragraph should be disclosed.

3. Other contingencies may exist where the outcome is reasonably foreseeable, such as probable tax assessments which will not be contested, or anticipated losses from uncollectible receivables. Contingencies of this type which are expected to result in losses should be reflected in the accounts. However, contingencies which might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization;[1] but there should be adequate disclosure.

4. There are also general risk contingencies that are inherent in business operations and which affect many if not all companies, such as the possibility of war, strike, losses from catastrophies not ordinarily insured against, or a business recession. Contingencies

[1] See Chapter 1, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins.*

of this type need not be reflected in financial statements either by incorporation in the accounts or by other disclosure.[2]

Disclosure

5. Disclosure of contingencies referred to in paragraph 2 should be made in financial statements or in notes thereto. The disclosure should be based as to its extent on judgment in the light of the specific circumstances and should indicate the nature of the contingency, and should give an appraisal of the outlook. If a monetary estimate of the amount involved is not feasible, disclosure should be made in general terms describing the contingency and explaining that no estimated amount is determinable. When amounts are not otherwise determinable, it may be appropriate to indicate the opinion of management or counsel as to the amount which may be involved. In some cases, such as a law suit involving a substantial amount, management may reasonably expect to settle the matter without incurrence of any significant liability; however, consideration should be given to disclosing the existence of the litigation and the opinion of management or counsel with respect thereto. Although disclosures discussed here should be made with respect to those contingencies which may result in material gains or assets as well as with respect to those which may result in material losses or liabilities, care should be exercised in the case of gains or assets to avoid misleading implications as to the likelihood of realization. The discussion in this bulletin does not deal with the question as to whether the existence of any of the contingencies discussed above is such as to require a qualified opinion or a disclaimer of an opinion by the independent certified public accountant.

6. Certain other situations requiring disclosures have sometimes inappropriately been described as though they were contingencies, even though they are of a nature not possessing the degree of uncertainty usually associated with the concept of a contingency. Examples are unused letters of credit, long-term leases, assets pledged as security for loans, pension plans, the existence of cumulative preferred stock dividends in arrears, and commitments such as those for plant acquisition or an obligation to reduce debts, maintain working capital, or restrict dividends. While some of these situations may develop into contingencies, they should not be described as contingencies prior to such eventuality.

The statement entitled "Contingencies" was adopted unanimously by the twenty-one members of the committee, of whom two, Messrs. Bedford and Halvorson, assented with qualification.

Mr. Bedford objects to the provision in paragraph 3 that anticipated losses due to a contingency should be recognized in an accounting period prior to the actual incurrence of the loss. He believes that such deductions from revenue, in order to match adequately costs and revenues, should be based upon sufficient statistical evidence or experience to justify an accounting treatment different from that afforded gains. Without the sufficient statistical evidence or experience and without evidence to indicate a loss has been incurred, he believes a contingent loss should be disclosed in such a manner as not to require the recognition of the loss until the loss has been incurred.

[2] For the committee's position with respect to contingency reserves, see Chapter 6 of Accounting Research Bulletin No. 43.

Mr. Halvorson believes the bulletin fails in the essential matter of definition in the second sentence of paragraph 1. He feels that "a considerable degree of uncertainty" is beside the point, and that the definition as it stands would not exclude many types of commitments. He believes that the point should be that the "existing condition" and the "related future event" would affect present financial position or present or past operations, and would be so recorded in the statements, if all the uncertainties could be resolved at the time the statements are being issued. He also believes that the bulletin should not deal with the "general risk" contingencies described in paragraph 4, as they are not of a peculiarly accounting nature, and the attempt to accommodate them in an accounting bulletin has required a definition that is so broad as to fail in its purpose.

Education and Communication

Another aim and aspiration whose sights should be raised is that of the quality and accuracy of communication—oral and written. Our business schools can devote relatively little time to cultural subjects but, quality of communication, though it has cultural aspects, is also an important tool of the professional accountant. In this respect there seems to be a serious underestimation of the importance of training in oral and written expression. . . .

To convey information correctly, words must be selected as thoughtfully as figures. Sentences and paragraphs must be arranged as logically as the items on balance sheets and operating statements. Those who are required to review accountants' writings complain about the surprising prevalence of inaccurate writing and poor style. In the category of inaccurate writing are included misstatements of facts, ambiguity, vagueness and incompleteness. In the category of poor style are included factors such as bad grammar, wrong words, incoherence, disorganized flow of material, and language just not satisfactory for inclusion in reports to clients and for use by others.

Those who deal extensively with financial statements realize the importance that attaches to each word and phrase in the opinion or disclaimer of an opinion contained in an annual report. The wording of footnotes to statements frequently calls for the most carefully studied phraseology. Turning to another branch of accounting—system work—the need for precise, lucid, logical communication in a memorandum on system revision is very obvious. The success of a system job may well depend on the clarity of the explanations and instructions. In these and in every other area of public accounting there is a vital need for good communication.

MAX BLOCK, "Some Aims and Aspirations,"
ACCOUNTING SEMINAR [Long Island University], Fall 1958

Significant Federal Tax Decisions of 1958

By ALBERT R. DWORKIN, CPA

During 1958, the machinery of the tax-decisions mill was as active as might have been expected, and several thousand decisions were handed down by the Tax Court, the various U. S. District Courts, the Court of Claims, the eleven Circuit Courts of Appeals, and the Supreme Court. This review scans the decisions handed down in the twelve months through November 1958 and attempts to report those reflecting new developments which would appear to be of interest to accountants as persons interested in the tax field, and will also refer to those decisions of the courts which, while not necessarily announcing novel principles, fell into areas deemed to be of particular interest to practicing accountants.

During 1958, the United States Supreme Court handed down certain particularly important decisions in the tax field, and each of these important decisions is referred to later herein. Because of the diversity of the subject matter and the extensive area covered by the decisions, this discussion is reported under certain broad categories, which are presented alphabetically. Accordingly, the order of presentation herein is no indication of the relative importance of each of the decisions.

ALBERT R. DWORKIN, CPA, *is a member of our Society's Committee on Federal Taxation. Mr. Dworkin, a frequent lecturer and writer on federal income taxation, is a partner in the firm of David Berdon & Co., Certified Public Accountants.*

Capital Gain or Ordinary Income

In a decision on five appeals reported as *Comm.* v. *P. G. Lake, Inc. et al.*, 356 U. S. 260 (April 14, 1958), the Supreme Court announced what may constitute a new doctrine as to whether dispositions of property give rise to capital gain or ordinary income. The subject matter of the litigation in each of the cases was a carved out "mineral payment," oil payments in four cases and a sulphur payment in the fifth case. Under the applicable state law, such carved out mineral payments constituted separable interests in real property, defined as "the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced." The transferor in each case owned a greater mineral interest, and conveyed this mineral payment which was thereby carved out of the mineral interest owned by the transferor. The court held that since only a fraction of the mineral interests owned by the transferor was transferred, the balance being retained, in that fashion the transferor retained a degree of con-

trol over the entire property. The court noted that the certainty of payout and even the timing of payout of the assigned mineral rights could be ascertained with a considerable degree of accuracy and concluded that, under such circumstances, the consideration received for the conveyance was paid because of transfer of a right to receive future income from extraction of the mineral, and not because of an increase in the value of the income-producing property. This decision has been compared with the earlier Supreme Court decision in *Helvering* v. *Horst*, 311 U. S. 112 (1940), which held the donor taxable on collections of bond interest coupons severed from the bond and legally and effectively disposed of by the bond holder by gift prior to the interest periods covered by the bond coupons. In each case the owner of the entire property, namely bond with coupons, or entire mineral interest, made an effective conveyance under the property laws of the jurisdiction. These oil payment decisions would seem to raise doubts as to whether capital gains are available on the splintering up of the aggregate rights in property and sale of a portion of those property rights.

Sales for the purpose of liquidation of the investment in a capital asset are usually held to produce capital gain. If the program of activity for liquidation of the capital asset is such as to constitute the conduct of a business, and the sales are made to customers of such business, the gain will be held to be ordinary income. While this question is essentially factual, the very substantial appreciation in the value of much real estate makes this question particularly important at the present time. *Altizer Coal Land Co. et al.*, 31 TC No. 10 (Oct. 15, 1958), considered certain land improved with a number of residential buildings owned by a corporation, and a lease to the land and buildings held by a partnership which sublet the residences. On termination of the lease, lessee had a right to buy the property at a value to be determined. Since lessor and lessee could not agree on value, they determined to pool their interests in a joint venture for sale of the property in such fashion as would be necessary in order to liquidate their combined interests. The Commissioner argued that the creation of such a joint venture constituted the creation of a business entity which held the properties for sale to customers. Most of the sales were made to the residential tenants. These facts were viewed by the tax court to create not a partnership relationship but a mere unification of the interests of the parties so that their respective interests might be realized through sale. Accordingly, no joint venture conducting business was deemed to be created, and the sales were deemed to be only liquidations of capital assets.

A subsidiary of the Pennroad Corp. had acquired considerable waterfront land in the port of Baltimore approximately 100 years ago. Some of the land had been leased and improvements had been placed on some of the land. The corporation over recent years made some small additional acquisitions of property. During the tax years in question, it made 33 sales in liquidation of land, most of which had originally been acquired a century ago. All but two of the parcels sold were unimproved and only one-third of the parcels sold had ever been rented. The Tax Court, 29 TC 914 (February 20, 1958), determined that even the limited degree of activity in sales and purchases of property of this corporation would be deemed sufficient to make it a dealer in such industrial land. The court of appeals for the Third Circuit in *Pennroad Corporation and Affiliated Companies*

v. *Comm.*, 2 AFTR 2d 6202 (Nov. 26, 1958), refused to disturb this ultimate finding of fact of the Tax Court.

Corporation Problems

The collapsible corporation provisions received appellate construction during the year in the Second, Third and Fourth Circuits. These decisions indicated that the judicial sweep of the collapsible corporation provisions would be broad, rather than narrow in effect. All of these cases dealt with distributions from, or redemptions or sales of stock of, real estate corporations financed by mortgage loans which were insured by the Federal Housing Administration, and in every case the decisions were adverse to the taxpayers.

In *Glickman* v. *Commissioner*, 256 F2d 108 (CA-2, June 5, 1958), the court held that if the intention to "collapse" the corporation existed at any time prior to realization by the corporation of a sufficiently substantial portion of the income from its properties, the corporation may be collapsible. The taxpayer had argued that the corporation could not be deemed collapsible unless the intention to so utilize it existed at the time of the construction. In this respect, the Second Circuit seems to state a rule that is even stricter than was contained in the regulations at Section 29.117-11. This court also considered and rejected the argument that a substantial portion of the corporate distribution stemmed from appreciation in the value of the land on which the corporation had constructed its building, and therefore such distribution was not collapsible. The court held that the funds here distributed were attributable to a mortgage on both the land and building and therefore the gain distributed was attributable to the entire property rather than to the separately appreciated land. The court also demonstrated its broad interpretation by holding that construction of the building was not completed until everything necessary to complete such construction in accordance with the original plans had been done, and expressly rejected the contention that when the construction had proceeded to so high a degree of completeness that a certificate of occupancy was granted, the period of construction should be deemed to have terminated.

In *Raymond G. Burge*, 58-1 USTC 9379 (CA 4-1958), the court rejected the taxpayer's argument that the distribution was made out of the proceeds of the loan and not out of any income-producing activity.

In *Edward Weil*, 252 F2d 805 (CA-2, March 6, 1958), the Second Circuit held that the word "principally" used in the collapsible corporation statute meant not that the corporation was formed or availed of principally for avoidance of taxes but that the corporation was formed or availed of principally for manufacture, construction, or production of property. This interpretation might cause any sale, etc. of stock in any corporation at a profit to possibly be subject to the collapsible corporation provisions unless the corporation had already realized the requisite portion of the profits from its produced, constructed or purchased property, regardless of the motives inducing the sale by the stockholder. Of course, if at least 30 percent of the stockholder's gain is not attributable to the "collapsible" property, the selling stockholder would not be subject to these provisions.

In *J. D. Abbott*, 258 F2d. 537 (CA-3, July 31, 1958), the property had been distributed out of the corporation prior to much of the construction work. The taxpayer's argument that the corporation had not done much of the construction was rejected on the ground that

during the period of corporate ownership most of the construction had been contracted for. This court also rejected taxpayer's argument that since the corporation had realized over 10 percent of the total profit, the collapsible corporation provisions could not be applicable, but held that the test is whether any substantial profit was realized after liquidation of the corporation.

Section 337 permits a corporation to adopt a plan of liquidation, dispose of its properties within one year after the adoption of the plan of liquidation, and, if liquidation is completed within that one year, generally to avoid corporate tax on the disposition of the properties. Similarly, any losses sustained on property disposed of during the one-year period permitted for liquidation are not recognized. This raises the question of when a plan of liquidation would be deemed adopted. In *Virginia Ice & Freezing Corp.*, 30 TC No. 132 (Sept. 26, 1958), its board of directors met on October 1, 1954, approved the sale of corporate properties at a loss, and ordered notice of a further directors' meeting on October 11 for the purpose of adopting a resolution for liquidation of the corporation. Such meeting was held on October 11, and on October 22 the stockholders also adopted resolutions permitting dissolution and liquidation of the corporation. The Commissioner argued that a plan of liquidation had been informally adopted at the October 1 meeting, and that the loss on sales made between that date and October 11 should not be allowed. Since the applicable Virginia law permitted adoption of a resolution to dissolve only at a meeting held upon notice, the Tax Court held that the adoption by the directors of the agenda at the October 1, 1954 meeting for the later meeting on October 11, 1954 did not constitute the adoption by the corporation of a plan of liquidation, and the losses on the dispositions between October 1 and October 11 were allowed.

During 1957, the Tax Court had created considerable consternation by its decisions in the case of *Joseph R. Holsey*, 28 TC 962, and *Bernard Zipp*, 28 TC 314, in which it was held that on a corporate repurchase of its shares from a stockholder, the remaining stockholders of the corporation were charged with dividend income. During 1958, the Third Circuit reversed the *Holsey* decision in 2 AFTR 2d 58-5660 (CA-3, September 3, 1958), but the Sixth Circuit affirmed *Zipp* in 1 AFTR 2d 1778 (CA-6, May 21, 1958). Mr. Holsey held an option on stock in the corporation and he was individually the owner of the remaining stock of this corporation. He assigned the option to the corporation which then reacquired the shares leaving Mr. Holsey the sole remaining stockholder of the corporation. The Third Circuit applied the familiar rule that if the stockholder had an enforceable obligation to repurchase the stock and a corporate distribution satisfied such stockholder's obligation, the stockholder might be charged with a dividend; but since Holsey had no obligation to acquire the stock but merely an option, the corporate reacquisition of its stock did not discharge any individual obligation. The mere fact that by reason of the corporate distribution in acquisition of the remaining outstanding shares, Holsey individually became the sole owner of the stock, did not benefit him in any fashion permitting the levying of a tax to him at that time. The *Zipp* case had somewhat unusual facts, but in a factual determination not contradicting the rule stated in the reversal of *Holsey*, the Sixth Circuit determined that the distribution made by the corporation there extinguished an obligation of the remaining stock-

holders. This controversy apparently was laid to rest in October 1958 when the Treasury Department issued TIR-109, announcing that it would abide by the rule of the Third Circuit in *Holsey*.

In *Aqualane Shores, Inc.*, 30 TC No. 48 (May 29, 1958), the Tax Court considered the effect to be given to a book entry on the incorporation of real estate individually owned by three individuals, where all of the capital stock of the corporation was issued to those individuals. A value of $250,000 was stated for the property at the time of conveyance to the corporation; $9,600 was assigned to capital stock and an indebtedness of about $191,000 was set up in favor of the stockholders on the corporation's books in connection with the realty transfer. Apparently, the purpose was to step up the basis of the property and the controversy related to the basis for gain or loss on the disposition of the property by the corporation. The book entry was held not to create an indebtedness, since it was not evidenced by any note, was unsecured, and no payments thereon had been made by the corporation to the stockholders. So viewed, this book indebtedness was deemed to constitute simply an evidence of proprietary interest in the corporation, and the transfer was held tax-free, limiting the corporation to the reduced transferor basis of $69,000 for the property.

Deductions—Generally

An important decision relating to 200% - declining - balance depreciation was entered by the U. S. District Court for the District of Delaware in the case of *Hertz Corp.* v. *U. S.*, 2 AFTR 2d 58-5350, DC Del. (July 17, 1958). This corporation, engaged in the automobile rental business, considered that its automobiles had a useful life of four years for depreciation purposes, whereas the Commissioner charged that a useful life of 26 months based on the experience of the taxpayer's business should be applied. Because of the automobile renters' preference for relatively new cars, Hertz disposed of its automobiles well before the expiration of their period of economic usefulness as automobiles. A depreciable life of less than three years would make the 200%-declining-balance depreciation method inapplicable. The court approved the Commissioner's test of average useful life in the taxpayer's business as the period measuring useful life for depreciation purposes. However, the court held that since the Commissioner's regulations had taken a contrary view until June 11, 1956, which was after the tax years in controversy, the taxpayer could be allowed the benefit of the depreciation method for which it contended, since in the exercise of sound discretion the change in regulations should only be applied prospectively. Accordingly, the Government established the principle for which it contended as to depreciable life, but the taxpayer achieved the refund which it requested. Since on this basis no appeal is indicated, it would appear that this decision may not finally determine the authoritative interpretation of the depreciable period of useful life.

The case of *Dab* v. *Commissioner*, 255 F2d 788 (CA-2, June 5, 1958, aff'g. 28 TC 1031), denied the claim of a purchaser of a leasehold covering land and a large building, that such purchaser should be allowed to depreciate the portion of his total cost applicable to the building over the useful life of the building, since the life of the building was less than the term of the lease. The Second Circuit held that absent proof that any part of the price paid for the leasehold was intended to be paid for the building, no cost could

be apportioned thereto. A second point in this case involved the construction of the effect of the lessee's right to cancel the lease at the expiration of 25 years of the 99-year term. The Tax Court and Court of Appeals both rejected taxpayer's argument that this right to terminate after 25 years on the part of the tenant made the lease the equivalent of a lease for 25 years with renewal rights. Accordingly, amortization of the lease cost was spread over the 99-year term.

In *Eli D. Goodstein*, 30 TC No. 124 (August 28, 1958), and *Abraham M. Sonnabend*, TC Memo. 1958-178 (entered September 26, 1958), the Tax Court denied interest deductions on nonrecourse loans obtained to carry very substantial purchases of U. S. Government bonds. All arrangements for purchase of the bonds, obtaining the nonrecourse loan secured by such bonds, and the payment of interest on such loan, were interdependent steps. It appeared that the taxpayer would not realize a net profit from the investment in the bonds if they were held to maturity, but his profit would come from the fact that his interest deduction would apply against ordinary income and a partially offsetting gain would take the form of a capital gain. The court held that these transactions were not entered into for profit, that there was no intention to create indebtedness, and that any monies expended by the taxpayer in connection with the purchase were non-deductible personal expenses. Appeals from these decisions are pending.

The Supreme Court passed upon the deductibility of expenses incurred by construction workers in maintaining themselves at the sites of employment, where they maintained a regular home for their families at another location. In *Peurifoy et al.* v. *Commissioner*, 2 AFTR 2d 6055 (Nov. 10, 1958), the Supreme Court held that construction work ranging from 8½ to 20½ months, obtained for the petitioners by their union local, at sites far from their family homesteads, constituted indefinite and indeterminate employment rather than temporary employment. It held that such construction workers were not engaged in business but were employees, and that for income tax purposes except in the case of temporary employment, their home would be at the locus of their activities for their employers. Their living expenses at the site were thus personal and not deductible.

In *Commissioner* v. *Janss*, (CA-8) 2 AFTR 2d 5927 (Oct. 20, 1958), traveling expenses and cost of meals and lodging of a student taking temporary summer employment as a common laborer on construction work in Alaska were disallowed since the summer job taken by this student, while temporary as to him, was not temporary work as to the employer, because other men were generally available in Alaska to do the work which the taxpayer performed.

Legal fees in connection with the obligations imposed upon a husband by reason of divorce or separation are ordinarily not deductible on the ground that they constitute personal expenditures. The case of *Harry S. Glick* v. *U. S.*, 1 AFTR 2d 1015, D. Ct. No. Dist. Illinois (January 30, 1958), concerned a certified public accountant whose ex-wife sued to set aside a property settlement on the ground that it had been obtained through fraud, threats, duress and misrepresentation. The District Court found that the taxpayer feared that failure to refute such claims would impair his professional standing and adversely affect his income potential. Legal fees and expenses incurred in defending himself against

these charges were allowed as a deduction because they bore a reasonable and proximate relationship to the production and collection of income and the management, conservation and maintenance of property held for the production of income. A similar point was considered in *Fisher* v. *U. S.*, D. Ct. Pennsylvania, 157 Fed. Supp. 364 (December 27, 1957). The court there allowed deduction of a portion of the legal fees paid in connection with a divorce, to the extent that such fees were paid to adjust the method of payments required from the husband in order to conserve and maintain income-producing property consisting of 4,630 shares of capital stock on which dividends of $4.00 per share had been paid for a number of years. The portion of the legal fees deemed for purposes other than conservation of this source of the taxpayer's funds was not claimed as a deduction.

Deductions of Businesses

The inter-relationship of penalty provisions under local laws and the federal income tax was interpreted by the Supreme Court under two sets of facts. Certain trucking operators paid substantial amounts in fines for violation of state highway statutes as to loading, etc. These truckers maintained that the highway rules were confusing, varied considerably between states and were in part revenue-raising measures for the states, rather than truly punitive in nature. The Supreme Court rejected all arguments that would tend to indicate that payment of these fines would constitute business expenses of the trucking operators, on the ground that to allow an income tax deduction for such fines would reduce the punishment for violation of the local law and thus would be contrary to public policy. Furthermore, as to penalties for innocent violations by trucking operators, the court held that the trucking operators were subject to a high degree of care in informing themselves with respect to the state regulations, and fines for non-willful negligent failure to observe the state regulations similarly would not be allowable for Federal income tax purposes on the public-policy ground. See *Tank Truck Rentals, Inc.* v. *Comm.*, 356 U. S. 30 (March 17, 1958) and *Hoover Motor Express Co., Inc.* v. *Comm.*, 356 U. S. 38 (March 17, 1958).

In *Comm.* v. *Sullivan*, 356 U. S. 27 (March 17, 1958), the Supreme Court allowed deductions for rent and wages paid in the operation of a gambling business illegal under Illinois law, pointing out that the regulations under the Federal excise tax on wagers treated gambling as a business, and recognizing that the salaries and rent paid would be ordinary expenses of such business. Accordingly, the income tax does not apply to the gross income of illegal businesses without recognition of the ordinary and necessary expenses of such businesses, but payments such as fines made expressly as the result of a violation of local law will not be allowed as income tax deductions.

Under the 1954 Code, no deduction is allowable for compensation constituting deferred compensation under a plan, except in the year of payment. In *Champion Spark Plug Co.*, 30 TC 26 (May 15, 1958), the directors voted to pay $33,750 to a disabled employee over a 30-month period. In the event of the death of such employee the payments were to be continued to his wife or to his estate. The employee had a disability which had been either caused or aggravated by the circumstances of his employment. The court held that the full liability for the series of payments to be made over the 30-month interval accrued as a deduction when

voted by the directors of the corporation and that such payment did not constitute deferred compensation under any plan as defined in Section 23(p) of the 1939 Code.

Qualified employees' trusts caused some tax litigation. In *Time Oil Co.* v. *Commissioner*, 2 AFTR 2d 5512 (CA-9, July 30, 1958), the Ninth Circuit held that promissory notes issued by a solvent taxpayer on the accrual basis were equivalent to cash in making timely contributions to a qualified employees' trust. This coincides with the position previously taken by the Third Circuit in *Sachs* v. *Comm.*, 208 F 2d 313 (1953), but is contrary to the position taken by the Seventh Circuit and the Tax Court in *Logan Engineering Co.*, 12 TC No. 113 (appeal dismissed Oct. 4, 1949).

The *Time Oil Co.* case, *supra*, also considered whether a variation in practice from the written plan would be a basis for retroactive disqualification. The court stated that the test should be that before disallowing deductions once approved there must be a finding that the variation from the plan somehow prejudiced the benefits to be received by the beneficiaries and somehow improved or increased the indirect benefits to the employer already inherent in the plan. Applying this test, the court found that certain actions of the management and trustees of the plan did not vary from the plan to such extent as to disqualify the plan.

Colorado National Bank of Denver, 30 TC No. 97 (July 21, 1958), considered a bank which transferred real estate to its pension trust under a lease-back arrangement coupled with a repurchase option. Upon a factual finding that the property had a fair market value in excess of the contribution claimed as a deduction, the court held this transfer an equivalent of cash satisfying the deductibility requirements.

Good accounting is not always the same as good tax accounting. In *National Bread Wrapping Machine Co.*, 30 TC No. 52 (June 10, 1958), the taxpayer sold bread-wrapping machines under an agreement providing for five days of free work for installation and demonstration. At the close of each taxable year the corporation set up a reserve for the estimated cost to it of installation of machines shipped but not installed. The Tax Court denied deduction for such reserve indicating that there was no accrual of any payment to be made to any person but simply an obligation to have some person do work in the future.

Deductible Expense or Capital Outlay

Sales catalogs having a useful life not likely to exceed one year are deductible as current expenses as the expenses are incurred. The cost of preparing a catalog having a useful life of several years, whose printing plates were saved and then modified for subsequent reprinting of the catalog, was held to constitute a capital expenditure in *Best Lock Corp., et al.*, 29 TC 43 (Nov. 29, 1957). Since the catalog was not released to customers during the year in which it was prepared, no part of the cost of such catalog was allowed as a deduction in the year incurred.

Legal fees in connection with the sale or purchase of property are capital expenditures, if the property is a capital asset. Similarly, attorneys' fees paid in connection with condemnation proceedings are capital expenditures. However, fees paid for the protection or conservation of property, or in the conduct of the ordinary activities of a business, are deductible. In *U. S.* v. *Pate*, 254 F 2d 480 (April 9, 1958), the Tenth Circuit held that legal fees paid in an attempt

to recover for the loss of property through negligence of the defendant were ordinary deductible expenses in connection with the conservation or protection of property held for the production of income, and were not required to be treated as an offset against the recovery which qualified for capital gain treatment as an involuntary conversion.

Estate Tax

A decision of very great importance in connection with tax planning for closely held corporations was handed down in the case of *Littick*, 31 TC No. 21 (October 24, 1958). Decedent and his two brothers each owned one-third of the capital stock of a family publishing business. One year prior to decedent's death from an incurable disease following a 22-month illness, the three stockholders entered into an agreement under which the surviving stockholders agreed to buy any deceased stockholder's interest in the corporation for $200,000. This amount represented a fair valuation at the time. Subsequent to the death, the remaining stockholders bought the shares for the $200,000 consideration but, at that time, the book value of the decedent's shares was $267,000. The Commissioner contended that the fact of decedent's incurable illness demonstrated that this agreement was part of an over-all testamentary plan to dispose of decedent's interest at less than the fair market value of his stock, and the stock should be valued for estate tax purposes without regard to the provisions of this agreement. The Tax Court held for the petitioner, finding that this agreement served a business purpose of keeping control of the business in the existing management, was an arms-length agreement equally affecting all of the parties, and the price fixed had been realistically arrived at.

Fraud Matters

In any case involving allegations of criminal tax fraud, accountants would be well advised to work only in collaboration with an experienced attorney. There is, however, a very wide area in this field in which the properly qualified accountant can render useful services.

In the case of *U. S.* v. *Massei*, 355 U. S. 395 (March 3, 1958), the Supreme Court held that on the basis of proof of increase in net worth, the Government could carry its burden of proving fraud in a criminal case even without proof by admissible evidence of a likely source of unreported taxable income accounting for the increase in net worth. So long as the Government comes forward with evidence negativing all possible sources of non-taxable income which might account for the increase in net worth, the necessity for proof of existence of a likely source of taxable income disappears. On the other hand, the rule established by the earlier Supreme Court decision in the case of *Holland* v. *U. S.*, 348 U. S. 121 (1954), was stated to be that if the Government establishes a likely source of omitted taxable income which may account for the increase in net worth, the Government will not also be required to negative all possible sources of non-taxable income but the burden shifts to the taxpayer to affirmatively establish that the increase in net worth was due to other sources.

Expenses such as legal or accounting fees in connection with the unsuccessful defense of criminal tax fraud allegations are non-deductible personal expenses. The decision in *International Trading Co., et al.*, TC Memo decision 1958-104 (May 29, 1958), allowed a deduction for the full portion of the legal fees relating to the determination of the civil liability for tax and fraud penalty,

and it also allowed a deduction for legal fees paid with respect to the successful defense against criminal charges by the wife, who had been indicted along with her husband.

Gift or Income

A number of corporations have chosen to make voluntary payments to widows or dependents of deceased employees by continuing to pay an amount equal to the salary of the deceased for a period of one or two years. The Commissioner had taken the position that those payments constituted taxable income to the recipient, rather than tax-free gifts. In *Florence S. Luntz*, 29 TC No. 72 (January 13, 1958), the findings of fact indicate that the decedent and his immediate family had owned 25 percent of the capital stock of the corporation, and the remaining shares were practically all held by close relatives. The corporation voted a payment equal to a continuation of salary to the widow of the deceased officer. In view of the absence of any corporate obligation to make such payments, the Tax Court held that the payments constituted gifts to the widow and were not taxable.

The Seventh Circuit held such payments taxable income on similar, but distinguishable facts in the case of *Simpson* v. *U. S.*, 2 AFTR 2d 6036 (Nov. 7, 1958), reversing a District Court decision reported at 52 AFTR 1772. The corporate employer in that case had an established policy of making such payments to widows of director-officers, and such policy had been manifested in resolutions of the board of directors at various times starting with the year 1910. Although the court seemed to find that there was no legal obligation on the part of the corporation to make the payment, it nevertheless concluded that the continued services of the decedent may very well have been induced by knowledge of the policy of the employer to continue such payments to the widow of a deceased employee, and such consideration would be sufficient to cause the payment to be income when received.

During 1958, in T. I. R. No. 87, the Commissioner announced that he would no longer resist refunds of taxes paid by such recipients on amounts voluntarily paid without any obligation on the part of the corporation during years covered by the 1939 Code. There has been no clear statement of a position by the Commissioner with respect to such payments for periods governed by the 1954 Code.

Board and lodgings "furnished" by the employer for the convenience of the employer do not constitute taxable income. *Boykin* v. *Commissioner*, 260 F2d 249 (CA-8, October 30, 1958), concerned a physician employed in a Veterans Administration hospital who was furnished with such quarters but a reduction in his stated basic compensation was made therefor. There was no other manner in which the physician could hold such employment under the regulations of his employer. The court held that the stated compensation and stated reduction for value of quarters furnished taken together constituted an employment for the net amount. Consequently, the quarters were "furnished" to the employee and the amount which the contract otherwise would have made payable to the employee for the value of such quarters was held not to constitute taxable income.

Employees accepting new positions requiring relocation are frequently reimbursed for their relocation expenses. In *U. S.* v. *Woodall et al.*, 255 F2d 370, the Tenth Circuit on May 6, 1958 held that such amounts paid to or for such new employees, even though paid in accordance with the conditions of their acceptance of their employment, constituted gross income. It then applied the

test laid down by the Supreme Court in *Peurifoy, supra*, that to constitute an offsetting deduction, "the job, not the taxpayer's pattern of living, must require the travel" and since these expenses were incurred to "obtain employment" rather than "in the course of an employment," no authority existed for allowance of the deduction. Of course, in the case of an employee whose post of duty is shifted by his corporate employer, reimbursement for the costs of such relocation at the request of the employer would be pursuant to the exigencies of the employer's business and would not constitute taxable income to the employee.

The Fifth Circuit created a conflict with the Third Circuit and the Tax Court on the issue of whether corporate property made available for use by shareholders at a rental charge less than the fair rental value would create income to the shareholder to the extent of the differential. In *Peacock* v. *Commissioner*, 256 F2d 160 (June 13, 1958), the Fifth Circuit reversed the Tax Court, holding that in the absence of an intention to cause the rental value to be received as compensation for services, such rental value should be considered a gift from the corporation to the shareholders and thus not taxable to the shareholders. The Tax Court currently maintains a contrary position, considering the amount taxable either as compensation or as gain.

Gross Income

Installment finance company arrangements with dealers in personal property created a twilight zone with respect to reserves contingently credited to the dealer by the finance company. During the year, the Fifth and Eighth Circuits said such contingent credits did not constitute income in the year of crediting whereas the Seventh Circuit followed the Tax Court position holding that income arose. The Fifth Circuit position is expressed in *Texas Trailer Coach, Inc.* v. *Commissioner*, 251 Fed. 2d 395 (January 7, 1958). In *Glover* v. *Commissioner*, 253 Fed. 2d 735 (April 23, 1958), the Eighth Circuit reached the same conclusion. In contrast thereto, in *Baird* v. *Commissioner*, 256 Fed. 2d 918 (June 20, 1958), the Seventh Circuit expressly rejected the reasoning of *Texas Trailer Coach, Inc., supra*, and other cases holding that at the time of the contingent credit the dealer realized income on the accrual basis. Although each decision is premised upon the terms of the financing agreement, there appears to be a sufficient similarity among the agreements used by the major finance companies to indicate that a final rule may eventually be reached on this point. Certiorari has been granted in *Glover, supra*.

An unusual decision was announced by the Court of Claims in the case of *William F. Perry* v. *U. S.*, 160 F. Supp. 270 (April 2, 1958). The taxpayer in 1942 had created a trust, for the benefit of a municipality providing that the corpus thereof was to be used for an addition to a library. In 1953 the municipality decided not to proceed with the library work and to return the corpus of the trust to the taxpayer. The taxpayer had taken a deduction for the contribution in 1942. The court required the inclusion of this recovery in taxable income under the tax benefit rule but held that the tax thereon should be limited to the tax which had been saved by him in prior years by deduction of his contributions to such charitable trust. The decision makes no reference to statutory authority for such treatment and it would appear this may be a dangerous precedent on which to rely.

Insurance premiums paid by corporations on life insurance policies upon

the lives of stockholder-officers had been held by the Tax Court in 1957 to constitute taxable income to the stockholders even though the corporation owned the policies. These decisions were reversed by the Tenth Circuit in *Sanders* v. *Fox*, 253 Fed. 2d 855 (March 20, 1958), and by the First Circuit in *Prunier* v. *Commissioner*, 248 Fed. 2d 818 (November 8, 1957). This question basically was similar to the indirect stockholder benefit theory applied by the Tax Court in the *Holsey* and *Zipp* constructive dividend cases referred to earlier herein. The reversals by the Circuit Courts of Appeals applied the established principle that payments which simply increase the value of corporate assets would not result in benefits taxable to the shareholders in the absence of any corporate distribution thereby. In each of these cases, the corporate payments of the insurance premiums were deemed to constitute capital expenditures increasing the value of corporate assets, namely the insurance policies.

Practice

A partnership engaged in the performance of professional engineering services was organized in 1946 and kept its books and filed its tax returns on the cash receipts and disbursements method. In 1948, the partnership directed its certified public accountants to install an accrual method of accounting. The partnership continued to file its tax returns on the cash receipts and disbursements method and never requested permission to change its tax reporting to the accrual method. Each year the accountants prepared memorandum journal entries converting all elements of income and expense of the partnership to the cash receipts and disbursements method. These adjusting entries were shown on accountants' working papers but were not physically entered on the partnership's books. The working papers were kept by the accountants and were made available to the examining internal revenue agents. In *Patchen* v. *Commissioner*, 2 AFTR 2d 5433 (CA-5, July 23, 1958), such accrual books and conversion journal entries in the possession of the accountants but available upon request by examining officers of the Treasury Department, were held to constitute a system of cash basis accounts properly supporting cash basis tax returns. This reversed the position of the Tax Court which had held that these journal entries on accountants' working papers did not constitute books of account and therefore that since the books of account were maintained on the accrual method, the tax returns should similarly have been filed on the accrual method.

A limitation on the effectiveness of private Treasury rulings is illustrated by the excise tax case of *Aran* v. *U. S.*, 1 AFTR 2d 1858, (CA-9, May 10, 1958), holding that the Treasury Department properly might reverse its ruling that a particular bottle warmer was not subject to manufacturer's excise tax, where such private ruling was not supported by a long and consistent administrative practice. Where such a ruling has had wide recognition, or if a taxpayer has relied to his detriment upon a private ruling issued to him, other decisions indicate that the Commissioner will be required to exercise his discretionary power to limit the retroactive effect of changes in rulings. This is illustrated by the District Court decision in the case of *The Hertz Corp., supra*, referred to earlier herein with respect to depreciation allowances.

In *The Colony, Inc.* v. *Commissioner*, 357 U. S. 28 (June 9, 1958), the Supreme Court held that the five-year statute of limitations, applicable under the 1939 Code in case of an omission

from the return of gross income exceeding 25 percent of the gross income reported, would not apply to an understatement of gross income by reason of excessive deductions in the return for cost of goods sold. Under the 1954 Code the lengthened statute of limitations (six years) applies only where the 25-percent omission is not disclosed in the return or any attached rider.

The case of *Holcomb*, 30 TC No. 33 (May 23, 1958), illustrates that failure to comply with the particular provisions of a given relief section does not necessarily deprive the taxpayer of his desired result. Mr. Holcomb completed an invention in 1945 and approximately one year later assigned to his wife an undivided half interest in his as yet unpatented invention. On that day, Mr. and Mrs. Holcomb entered into a licensing agreement which, in the tax years in question, adequately assigned all of the rights to manufacture, use and sell the patented item so that the royalties payable under such agreement were deemed to constitute proceeds of sale of the patent. Mr. Holcomb satisfied the technical requirements of Section 117(q) and under such special provision was entitled to capital gain, but Mrs. Holcomb did not qualify under the special tests of Section 117(q). The Tax Court nevertheless determined that Mrs. Holcomb, under the general rules, was deemed to have sold her interest in the patent and entitled to capital gain as to the royalties payable to her under the licensing agreement.

The election to have a corporate liquidation taxed under Section 112(b)(7) of the 1939 Code (one-month liquidation) was held by the Tax Court in *Shull*, 30 TC No. 82 (June 30, 1958), not to be subject to revocation on the ground of mistake of law or mistake of fact. On examination by an internal revenue agent, it appeared that the corporation's earnings and profits were substantially greater than taxpayer's accountant had estimated, because the accountant had not given effect to capitalized earnings of a predecessor corporation. It was determined that these estimates of the accountant and his projections of the amount of ordinary dividend income did not constitute or result in mistakes of fact or law, even though the resulting dividend income on the liquidation was substantially greater than the stockholders expected when they filed the notices of election. This case would appear to constitute authority under the provisions of Section 333 of the 1954 Code.

In *Flora* v. *U. S.*, 357 U. S. 63 (June 16, 1958), the Supreme Court held that a taxpayer might not claim the right to sue for refund in the U. S. District Court or Court of Claims by paying only a portion of an asserted income tax deficiency. Accordingly, in the event that the taxpayer wishes a judicial review before full payment of the tax deficiencies asserted by the Government he must avail himself of the right to appeal to the Tax Court of the United States.

The Supreme Court also passed upon the extent of the transferee liability of a beneficiary of life insurance, for income tax deficiencies of the insured decedent. In *U. S.* v. *Bess*, 357 U. S. 51 (June 9, 1958), and *Commissioner* v. *Stern*, 357 U. S. 39 (June 9, 1958), it was held that if a federal lien had been perfected during the lifetime of the insured, the beneficiary would be liable for income tax obligations of the decedent but only up to the cash surrender value of the policy at the time of the death. If no lien had been perfected before such death, then the provisions of the applicable state law would govern to determine to what extent, if any, the Treasury as a creditor could look to proceeds of life insurance on the life of its debtor.

New York State Tax Forum

Guest Editor—FRANK M. BUDIK, CPA

Year of Deductibility of Additional New York State Franchise Tax

New York allows as a deduction the franchise tax on the period immediately preceding the period covered by the report being filed. Changes made in the federal return must be reported to the state. Upon receiving such information the state assesses the taxpayer for any additional New York State tax due on the particular year's report covering the federal examination. It does not adjust for the refund due on the subsequent year's New York report due to the additional deduction for the increased tax. Accordingly it would be necessary for the taxpayer to file an application for refund. We understand, however, that in cases where the additional New York tax is not a large amount, the state will permit the taxpayer to claim the deduction in the report filed for the year in which paid. Of course, the allocation percentages for each year should not be substantially different. This would appear to be an efficient way of handling the matter.

Federal Code Section 337 Liquidation

Federal law permits a corporation, which adopts a plan of complete liquidation (on or after June 1, 1954) and, within the twelve-month period of the adoption of the plan, distributes all of its assets less those retained to meet claims, non-recognition of gain or loss from the sale or exchange of its property within the twelve-month period. The New York authorities follow the same rule for franchise tax reporting purposes. There must be attached to the New York report the same information required by the Federal government under Reg. Sec. 1.337-5.

Indebtedness of Subsidiary to Parent—Possible Tax Savings

Indebtedness of a subsidiary to a parent on which any interest is deducted by the subsidiary in computing any New York franchise tax imposed on the subsidiary, may not be included in subsidiary capital of the parent. Such indebtedness is included in investment capital if evidenced by a bond or other corporate security; otherwise (as where the indebtedness is on open account), it constitutes business capital. Likewise, the income would be investment income or business income depending on the capital classification. Where the interest is not claimed as a deduction by the subsidiary the indebtedness is included in subsidiary capital of the parent and any interest (subsidiary income under these circumstances) received thereon is excluded from the parent's entire net income. In arriving at the entire net income of the subsidiary, interest on indebtedness paid to a parent by the subsidiary (if claimed as a deduction) is only deductible to the extent of $1,000 or 10 percent thereof, whichever is greater. Should the subsidiary forego

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ED. NOTE: For an interim period, until a permanent departmental editor has been selected, this department will be conducted by guest contributors.

such reduced interest deduction the parent would be taxed on the indebtedness at the low subsidiary capital tax rate and, as mentioned above, would exclude the interest income from its entire net income thus creating a possible tax savings.

The accountant should make computations to reflect the effect on the combined taxes of the parent and subsidiary with and without the interest deduction. The most advantageous way of filing the reports may be dependent on the allocation percentages of the parent and subsidiary and not alone on the fact of regarding the indebtedness as subsidiary capital.

Forms—New York State Franchise Tax Reports

As May 15, 1959, the date for filing many New York State franchise reports for business corporations (Form 3 CT) approaches, a reminder may be in order. The state requires the information called for by the report to be typed on the form itself and only allows schedules to be attached where the form does not provide the necessary space. For example, Schedule C of Form 3 CT (balance sheet and computation of capital) does not call for any detail schedules for assets or liabilities at the beginning and end of the year. Accordingly, the amounts should be entered on the report and no schedules need be attached. The foregoing is pointed out since in some instances details are required for the federal return and one is apt to use the same schedules for the state report without inserting the amounts on the form. Under such circumstances, New York State will return the report for its proper completion. This is not only inefficient but could be embarrassing to the accountant.

Real Estate Corporation— Loss of Classification Due to Investments in Securities

A real estate corporation will lose its status as such under Section 182 of Article 9 of the New York State Tax Law and become taxable as a business corporation under Article 9-A if during any year more than ten percent of its average gross assets, at full value, is invested in stocks, bonds or other securities. In determining whether the ten-percent limitation has been exceeded, the amount invested in "securities" is averaged and compared percentagewise with average gross assets. The fact that the dollar amount invested in "securities" at any one time during a year exceeds ten percent of average gross assets, will not disqualify a real estate corporation from being taxed under Article 9. Average "securities" and average gross assets may be determined on an annual, quarterly, or monthly basis. Thus, average "securities" on an annual basis may exceed ten percent of annual average gross assets, but on a quarterly or monthly average basis it may be less than ten percent. The method used should be consistent for both bases.

Personal Income Tax—Foreign Income Tax on Dividends

The personal income tax law does not allow a deduction for income taxes paid by a taxpayer. Where dividends are received from a Canadian company, Canadian income tax at source is withheld and the remittance covers the dividend net of tax. The recipient must include the amount of such dividend before tax in the New York return. However, it should be noted that where foreign income tax is paid the question of whether the tax was imposed on the recipient or the corporation paying the dividend should be looked into. For example, the British income tax is imposed on the corporation and accordingly the dividend to be reported in the recipient's New York return is the net amount. For federal tax purposes, of course, the treaty with the United Kingdom allows the recipient to claim credit or deduct such tax imposed on the corporation.

Accounting at the SEC

Conducted by LOUIS H. RAPPAPORT, CPA

The complete text of the SEC's Accounting Series Release No. 82, issued January 28, 1959, is reprinted below. The release is entitled "In the Matter of Bollt and Shapiro, Theodore Bollt, and Bernard L. Shapiro."

Where partner of accountant certifying financial statement in registration statement filed with Commission pursuant to Securities Act of 1933 is the principal officer and controlling stockholder of the registrant, *held*, certifying accountant is not independent with respect to registrant.

Where one partner in firm of certified public accountants who was the principal officer and controlling stockholder of company which filed a registration statement with the Commission caused the other partner to certify registrant's financial statement as an independent public accountant, *held*, firm and both partners engaged in improper and unethical professional conduct, and privilege of practicing before the Commission should be denied to the firm and the partner controlling registrant until they obtain the approval of the Commission, and the privilege to practice before the Commission of the certifying accountant should be suspended for 30 days.

Appearances

Ellwood L. Englander, and *Alger B. Chapman, Jr.*, of the Office of the General Counsel, for the Office of the Chief Accountant of the Commission.

Francis T. Greene, of Surrey, Karasik, Gould and Efron, for respondents.

These are proceedings under Rule II(e) of our Rules of Practice to determine whether Bollt and Shapiro, a partnership of certified public accountants ("B&S"), and Theodore Bollt and Bernard L. Shapiro, the partners therein, should be denied, temporarily or permanently, the privilege of appearing or practicing before us.[1]

LOUIS H. RAPPAPORT, CPA, *a partner in the firm of Lybrand, Ross Bros. & Montgomery, CPAs, is the author of* SEC ACCOUNTING PRACTICE AND PROCEDURE.

[1] Rule II(e) provides:

"The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter

"(1) not to possess the requisite qualifications to represent others; or

"(2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

The order instituting these proceedings alleges that respondents engaged in unethical and improper professional conduct in that Shapiro certified as an independent accountant the financial statement included in a registration statement filed by a company of which his partner Bollt was the promoter, principal officer and controlling stockholder, and in that Bollt and Shapiro sought to conceal from us their relationship as partners in their accounting firm.

Respondents filed an answer to the order for proceedings, and after appropriate notice a private hearing was held before a hearing examiner. Proposed findings, briefs and reply briefs were filed by the respondents and by the Office of the General Counsel on behalf of the Chief Accountant of the Commission ("Staff"). The hearing examiner submitted a recommended decision in which he concluded that B&S, Bollt and Shapiro had engaged in unethical conduct and recommended that each of them be denied the privilege of practicing before us for a period of 15 days. Thereafter, exceptions and a supporting brief were filed by the respondents, and exceptions and a reply brief were filed by the Staff, and we heard oral argument. On the basis of an independent review of the record we make the following findings and conclusions.

Bollt and Shapiro are certified public accountants and members of the American Institute of Certified Public Accountants ("AICPA"). Bollt has been a certified public accountant since 1942 and Shapiro since 1948. The partnership was formed in 1951, and its clients are mainly small closely-held businesses, none of which has securities widely held by public investors. Most of the firm's clients were obtained through Bollt.

Bollt is the principal promoter, president, treasurer, director, and owner of the majority of the voting stock of the Motel Corporation of Italy ("registrant"), whose address is the same as that of the respondent partnership. In January 1958 Bollt caused registrant to file a registration statement[2] under the Securities Act of 1933 ("Act"), covering a proposed public offering of securities having an aggregate offering price of approximately $1,000,000. The registration statement included registrant's balance sheet, which was certified by Shapiro as a certified public accountant. The registration statement was withdrawn after registrant was advised by our Division of Corporation Finance ("Division") that such statement failed to meet the requirements of the Act.[3]

Lack of Independence of Certifying Accountant

Schedule A of the Act, which specifies the information and documents required in a registration statement, provides that financial statements be furnished which are certified by an independent public or certified accountant. Rule 2-01 of our Regulation S-X states that we will not recognize any accountant as independent who is not in fact independent, and cites as an example that an accountant will be considered not independent with respect to any person or any affiliate thereof in whom he has a financial interest or with whom he is connected as a promoter, director, officer or employee. The rule further states that in determining whether or

[2] File No. 2-13845.

[3] A prior registration statement (File No. 2-13789) had also been withdrawn by registrant after it had been advised by our Division that such statement failed to meet the requirements of the Act. Among other asserted deficiencies, the prior statement failed to include an accountant's certificate with respect to the financial statements therein.

not an accountant is in fact independent with respect to a particular registrant, we will give appropriate consideration to all relevant circumstances, including all relationships between the accountant and that registrant or any affiliate of that registrant,[4] and will not confine ourselves to the relationship existing in connection with the filing of documents with us.

Shapiro's relationship as a partner of Bollt, who is a promoter, director, officer, and controlling stockholder of registrant and therefore an affiliate thereof, rendered him not independent with respect to registrant and accordingly disqualified him from certifying its financial statement. This is clear not only from a reading of Rule 2-01 but also from our prior decisions and published releases.

In *Richard Ramore Gold Mines, Ltd.*, we held that an accountant who was an employee or a partner of another accountant who was a substantial stockholder of a company was not independent with respect to certifying that company's financial statements. We stated that the purpose and intent of the requirement of certification by an independent accountant would be defeated and evaded if the stockholder-accountant is disqualified but his partner or employee is not.[5] Under this principle we have held that an accounting firm could not be considered independent for the purpose of certifying the financial statements of a corporation in which one member of the accounting firm owned a substantial amount of stock.[6] The same conclusion of non-independence was reached when one partner of the accounting firm merely served as a member of the board of directors, even though such partner did not participate in any way in the audit and another partner certified the financial statement in his own and not the firm's name.[7]

Rule 13 of the Rules of Professional Conduct of the AICPA provides that a member shall not express an opinion on financial statements of any enterprise financed by the public distribution of securities if he or his immediate family has a substantial financial interest in such enterprise. As respondents concede, this rule, as interpreted by the Committee on Professional Ethics of the AICPA, precludes a public accountant from rendering an opinion with respect to an enterprise financed through the public distribution of securities if his partner in the practice of accounting has a substantial interest in the enterprise.[8]

The lack of independence of a partner in a public accounting firm affects the partnership and every other partner. Bollt himself was admittedly not qualified to give an independent report on the financial statements of the company he controlled; we find that his partner Shapiro and the partnership itself were equally lacking in the requisite independent capacity.

Unethical and Improper Professional Conduct

Respondents contend that we should not find them to have engaged in unethical or improper professional conduct. They assert that Bollt and Shapiro

[4] Under Rule 1-02 of Regulation S-X, an affiliate of a specified person is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

[5] 2 S.E.C. 377, 389 (1937).

[6] Accounting Series Release No. 2 (May 6, 1937).

[7] See Accounting Series Release No. 47 (January 25, 1944), Examples Nos. 8 and 9.

[8] Interpretation of Rule 13, *CPA Handbook*, American Institute of Accountants, Vol. I. App. A, pages 7-8.

had had no prior experience with matters before us, were unfamiliar with our rules, decisions and releases and the interpretation of the AICPA regarding independence, and in good faith concluded that Shapiro could be considered independent because he himself had no financial interest in or position with registrant.

Bollt and B&S

Bollt recognized that he himself was not qualified, because of his substantial financial interest and controlling position, to furnish an independent report regarding registrant's financial statement. He testified that he discussed the selection of Shapiro to certify the financial statement with his attorney, Sol M. Alpher, who helped prepare the registration statement and who was also secretary and a director of registrant and signed the registration statement. Bollt asserted that he was familiar with the AICPA rules, but had not read our rules or decisions or the AICPA interpretation of its rules regarding independence of public accountants, nor had he made any inquiries of our Staff. Instead he relied on Alpher's opinion that Shapiro was independent within the intent of the registration requirements.

In our opinion any common sense interpretation of independence would have led to the conclusion that the partner of the promoter and controlling stockholder of an enterprise is not independent with respect to the enterprise, and the parties concerned should have realized that at the very least such a relationship should be disclosed. We consider it significant in this connection that nowhere in the registration statement was any mention or disclosure made of the fact that Bollt and Shapiro were partners, although such information was required in response to one item in the registration statement and this fact or the fact that they had a common business address could have been reasonably expected to be mentioned in two other places.

Bollt signed the registration statement as a principal officer and director of registrant. One item of the registration statement, entitled "Relationship with Registrant of Experts Named in Registration Statement," calls for the disclosure of any substantial interest in registrant or its parents of the accountant certifying the financial statements. Bollt, as a person who controlled registrant, was a parent of registrant within the definition thereof in Rule 1-02, and Shapiro, in view of his partnership with Bollt, had a substantial interest in Bollt. Yet no disclosure of the partnership was made.

Under another section of the registration statement entitled "Management," there is a biographical description of registrant's officers and directors including Bollt. The description of Bollt lists his business activities and membership in fraternal and civic and professional groups, but omits any reference to his partnership with Shapiro and merely stated that he is in "active practice in Maryland as a Certified Public Accountant." While there is no specific requirement that the partnership be mentioned at that point, the omission is significant in view of the detailed list of Bollt's other activities and affiliations.

Finally, Shapiro's certificate included in the registration statement was not on the partnership's printed letterhead but on a blank sheet of paper upon which Shapiro's home address was typed. Alpher testified that he inserted Shapiro's home address in order to indicate that Shapiro was acting in his individual capacity and not as a partner in B&S. However, had Shapiro's business address been used, his rela-

tionship with Bollt and registrant would have been apparent, since all of them have the same business address and the business address of Bollt and registrant is listed in the registration statement.

Bollt asserts that he was unfamiliar with our rules and decisions on independence, as well as with the interpretation of the AICPA rules thereon; that he delegated to Alpher the task of preparing the registration statement and resolving all related legal problems, and relied on Alpher's determination that Shapiro was independent; that the partnership between Bollt and Shapiro was a matter of public record and was disclosed in listings in the local telephone and accountants' directories; and that Bollt carelessly signed the registration statement without noticing the omissions respecting the partnership relationship, and did not designedly conceal the partnership relationship or cause Shapiro to certify the balance sheet notwithstanding his lack of independence.

We do not find these assertions persuasive, and we agree with the findings of the hearing examiner that Bollt caused his accounting partner Shapiro to certify as an independent accountant the balance sheet of a registrant controlled by Bollt, and that Bollt attempted to conceal from us and the public his relationship with Shapiro.[9] In view of the complete omission from the registration statement of any mention of Bollt's relationship with Shapiro or of any fact, such as a common business address, which might have suggested any such relationship, we are convinced that Bollt recognized Shapiro was not qualified to furnish an independent certification and sought to conceal this from us and from the purchasers.[10] We conclude that Bollt and B&S engaged in unethical and improper professional conduct in connection with the certification of registrant's balance sheet by Shapiro.

Shapiro

Shapiro knew that he was certifying registrant's balance sheet for inclusion in a registration statement which was to be filed under the Act in connection with a proposed offering to public investors of approximately $1,000,000 of securities, and that such certification was required to be that of an independent public accountant. Shapiro testified that he had read Rule 13 of the Rules of Professional Conduct of the AICPA, which does not on its face specifically refer to the situation of a partner of an affiliate of a registrant, but that he did not know of the published interpretation of that rule which did relate to such situation, and that, after discussing the question with Alpher, he relied on the latter's opinion that he was qualified to certify registrant's balance sheet notwithstanding his partnership with Bollt.

Shapiro was charged with the professional responsibility of familiarizing himself with our accounting and auditing rules to which his client was subject.[11] He was aware that his partner-

[9] Bollt testified that he disclosed the partnership with Shapiro in a conference with members of the Division after the filing of the registration statement. The staff members present testified, however, that no such disclosure was made.

[10] Respondents imply that Alpher himself may have tried to conceal from us the partnership relationship, and assert that Bollt was unaware of any such scheme on Alpher's part and should not be held responsible therefor. However, it is not reasonable under all the circumstances to believe that the attorney would embark upon such a course of conduct in behalf of his client without the client's knowledge and acquiescence.

[11] Cf. *CPA Handbook*, American Institute of Accountants, Volume I, Chapter 5, pages 23-24, where it is stated that an accountant who has failed to familiarize himself with the accounting or auditing rules of a government agency affecting his client may be subject to discipline.

ship with the person who controlled registrant was material to the question of his independence, and he should have realized that it precluded him from certifying registrant's financial statement. Any doubt in Shapiro's mind could have been easily resolved by recourse to our rules, accounting releases, published opinions, the interpretation of the rules of the AICPA, and the informal advice of our Staff, any one of which would have indicated to him the lack of independence. Instead he merely accepted the opinion of Alpher who was an officer and director of and an attorney for the very enterprise as to which Shapiro was required to be independent.

We conclude that Shapiro engaged in improper professional conduct in not inquiring into and becoming familiar with our requirements regarding independence, in relying on the opinion of Alpher, and in certifying registrant's balance sheet as an independent public accountant when he was not in fact independent with respect to registrant either under our rules or under generally accepted accounting standards.

The hearing examiner did not find that Shapiro sought to deceive us. We are in accord with the hearing examiner in this respect, and we find that the record, which shows that Shapiro did not participate in the preparation of the text of the registration statement and that his home address rather than the firm address was placed on his report after he signed it and without his knowledge, does not establish that Shapiro sought to conceal from this Commission his relationship with Bollt.

Conclusions

Respondents urge that disciplinary action is not required. They point to the fact that registrant's balance sheet was a short and simple document and no charge has been made with respect to its adequacy or accuracy and contend that in other cases in which we have taken disciplinary action against public accountants we found that the financial statements themselves contained false or misleading representations.

The requirement in the Act that certification be by an independent accountant is a basic one and reflects the importance to investors and the public of an audit by accountants not connected with the company or its management.[12] That registrant's balance sheet was not complex and its accuracy and completeness have not been questioned in these proceedings, does not either cure or reduce the importance of the lack of independence by the certifying accountant.[13]

The false representation of independence of a certifying accountant constitutes serious improper professional conduct and provides a basis for disciplinary action. In taking disciplinary action against an accountant on the ground, among other things, that he was not independent of his client, we stated in *Kenneth N. Logan* that, when an ac-

[12] See *Cornucopia Gold Mines*, 1 S.E.C. 364, 367 (1936); Accounting Series Release No. 22 (March 14, 1941).

[13] See *A. Hollander & Son, Inc.*, 8 S.E.C. 586, 613 (1941), where, in a stop order proceeding, we stated:

"We cannot, however, accept the theory advanced by counsel for the intervenors that lack of independence is established only by the actual coloring or falsification of the financial statements or actual fraud or deceit. To adopt such an interpretation would be to ignore the fact that one of the purposes of requiring a certificate by an independent public accountant is to remove the possibility of impalpable and unprovable biases which an accountant may unconsciously acquire because of his intimate non-professional contacts with his client. The requirement for certification by an independent accountant is not so much a guarantee against conscious falsification or intentional deception as it is a measure to insure complete objectivity."

countant who is in fact lacking in independence represents, by his certifications to be filed with us, that he is independent, that circumstance is relevant to the issue of his character and integrity and the propriety and ethics of his professional conduct.[14]

Even apart from the requirements of the Act and of our rules, it is firmly established under generally accepted accounting standards that independence is the keynote of the public accounting profession.[15] Authorities in the profession have repeatedly stressed that the public accountant's primary asset is his independence and integrity, and that he is impelled not only by enlightened self-interest, but also by rules of professional conduct, to maintain his independence at all costs.[16]

Bollt's conduct, which as we have found involved a deliberate concealment of the partnership relationship between him and Shapiro, whom he caused to certify the financial statements despite such relationship, requires that we exclude him and his firm from practicing before us. In the case of Shapiro, as to whom no intentional concealment has been established, he evidenced a careless and unprofessional attitude with respect to a most fundamental concept under both the Act and Accounting Standards.

After a careful consideration of all pertinent factors, including those stressed by respondents, we are of the opinion that respondents Bollt and B&S should not be permitted to practice before this Commission in the future until they obtain our approval, and that respondent Shapiro should be denied the privilege of practicing before us for a period of 30 days.

Rulings on Exceptions

We have examined the recommended decision of the hearing examiner and the exceptions thereto, and to the extent such exceptions involve issues which are relevant and material to the decision in this case, we have by our opinion herein already fully ruled upon them. We hereby expressly sustain those exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule those exceptions to the extent that they are inconsistent with such views.

An appropriate order will issue.

By the Commission (Chairman Gadsby and Commissioners Orrick, Patterson, and Sargent), Commissioner Hastings being absent and not participating.

ORVAL L. DUBOIS
Secretary

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[14] *Accounting Series Release No. 28* (January 8, 1942).

[15] The council of the AICPA has stated:

"Independence, both historically and philosophically, is the foundation of the public accounting profession, and upon its maintenance depends the profession's strength and its stature . . . It has become of great value to those who rely on financial statements of business enterprises that they be reviewed by persons skilled in accounting whose judgment is uncolored by any interest in the enterprise . . ."

CPA Handbook, American Institute of Accountants, Ch. 5, pp. 16-17.

[16] *Montgomery's Auditing* (7th Ed., 1949), page 22; Address by the Research Director of the AICPA, printed in THE JOURNAL OF ACCOUNTANCY, December 1946, p. 453.

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, CPA

Filing and Related Routines

Though this subject is dealt with occasionally in accounting literature and deliberations, current interest nevertheless continues at a high level. A few questions on the subject were recently submitted to members of our Society's Committee on Administration of Accountants' Practice to ascertain the practices employed by their offices. Some responses are here summarized.

Are File Rooms Kept Locked? Generally, no. Files containing confidential client and firm papers, kept in the file room, are locked.

Is Access to the File Room By Staff Unlimited? Generally, yes. Staff members usually are permitted to remove papers at will. In some instances an "out" card is employed to indicate when and by whom papers were removed. Where a file clerk is employed, such person handles the files, though staff may still remove papers directly when the clerk is not present.

Papers are returned to the files by the file clerk, where one is employed; otherwise by employees who are juniors, part-time students who do office work and secretaries. One firm permits staff men to file folders but loose papers are filed by a file clerk.

Instructions for Opening New Files. Firms that use a "New Client" form control the opening of files and folders for new clients by a provision on the form. The form is routed to the file clerk or other employee who acts according to the stated instructions. Where no control form is used, new files are opened by whoever is required to file papers for which there is no existing file.

New annual files are opened by the file clerk or staff accountants.

Transfer Files. There is a common pattern for maintaining the currency of the current files. It comprises a two-step program, to wit: First, files more than two to three years old are transferred to either a transfer file, shelves in the file room, or to a basement room in the office building or a partner's home. Some destruction of papers takes place at this point, largely of confirmation forms and inventory papers of a non-permanent nature. When the sec-

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ondary files are crowded, there is a more extensive destruction of out-dated papers and the balance is sent to a public warehouse.

Controls of files not in the current file section are kept on cards for individual clients. Each card contains a listing of the files in secondary storage by file numbers, location (if there is more than one storage place) and a brief description of the contents in each folder. Thus, if papers for a particular old year are required, the secondary storage card should readily disclose their location.

Guarding Papers. One correspondent advised as follows:

"There is no specific safeguard regarding papers in transit and on the jobs. Naturally, staff men are urged to be careful and see to it that their briefcases are locked when they go out for lunch and that the papers are removed from the client's premises overnight. Only under rare circumstances are the papers allowed to remain at the client's premises overnight and only if they can be placed in the client's safe. We carry a 'valuable papers' insurance policy but we have not ever had an occasion to make a claim."

Another stated: "We have never considered our files a great problem. Despite the fact that staff men remove papers from the file room freely, we are not troubled with lost or misplaced papers. We do, however, insist that once an audit or tax file is bound that it must stay so; no papers are to be taken from a bound folder without the express permission of a principal or partner."

A third correspondent advised that, "Jobs are reviewed immediately upon their completion, and a check is made at that time to see that papers are returned to the office."

Final Disposition of Papers. This is probably the most irritating and time-consuming problem for principals and one whose difficulties become cumulatively greater with growth and the passage of time, unless there is a disposal program. The following practices were reported:

"Each year we purge our files of certain audit and correspondence files to eliminate from them detail which is no longer of value. For example, accounts receivable confirmation replies and records of inventory observations are destroyed in the third year following the audit date. A destruction note is put in the audit file to indicate that such papers have been destroyed.

"Chronological correspondence files are destroyed in the third year after their origination. Correspondence filed under client's names or subject matters are retained indefinitely.

"Miscellaneous correspondence, such as hotel reservations, instructions to out-of-town staff men regarding assignments, and letters to suppliers are not permanently filed at any time."

Another response indicated that (to this date, assumedly) the only papers destroyed are confirmations over one year old. Another indicated that partners review the files every two years to designate the material that may be destroyed.

An excellent article on this subject for accountants, by George N. Farrand, CPA, will be found in the December 1948 issue of THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT. An excellent pamphlet on this subject, suitable for accountants as well as for their clients, can be obtained from the Bankers Box

Company, 2607 N. 25th Avenue, Franklin Park, Illinois.

Handling "Inability to Pay" Fee Problems

Accountants are often confronted with problems of client's inability to pay a fair fee. Some such clients may eventually prosper and ultimately reward the accountant well, in the future; others may not. Some such clients may never make the grade and the accountant's investment in free time will become a total loss. Truly the accountant faces a dilemma in these instances.

To reach a decision on whether to speculate one must assure himself as well as he can on these counts:

(a) Does the client appear to have the competence and other requisites for eventual success?

(b) Is the client so constituted as to recognize the accountant's initial sacrifices and be willing to compensate therefor when able to?

(c) Is the company in an industry and area that has room for growth and reasonable profits?

(d) Are there tangential benefits from the association that may justify an initial sacrifice?

This subject was commented upon by Max Klein, CPA, of Jacques M. Levy & Co., at a recent technical meeting of our Society, and his remarks are very deserving of consideration and are here reproduced.

Obviously the most desirable approach from the accountant's point of view is to convince the client that he cannot afford to do without the service and that the accountant cannot afford to work for substandard fees. An offer to extend the time over which payments are due might help to accomplish this logical turn-around.

Another, better than nothing approach, is to bridge the gap, between the fee that the client will pay and the fee required by the accountant by a series of scheduled gradual increases. These can be spaced over the period of a few months or even a year or two. In any event the end result should be an adequate fee.

On this same subject of inability to pay—and sometimes it is more unwillingness to pay than anything else—I would like to spell out a warning for the benefit of those practitioners who are in the early stages of building a practice. I am sure that the established practitioner will agree with me. Before fixing any fee, consider carefully what is necessary to carry on a successful well-administered practice. Consider the amount of time that must be devoted to professional reading and study; consider the time required to properly run an office and train a staff; consider the free time necessary to participate in the activities of professional societies, community organizations and consider also the free time you would like to have for family and social activities and healthful relaxation. If all of the time requirements are taken into account there is one inescapable conclusion and that is that accounting fees should be high. The practitioner who ignores this often winds up with a practice that produces only a modest income yet takes all his time. This practitioner is in a rut. He is busy servicing his practice in order to make financial ends meet and does not devote the time necessary to improve his stature so that he can command larger fees. It is an endless cycle.

This dilemma can best be avoided at the beginning when the accountant should devote himself to the problem

of how to secure an adequate fee arrangement while he is working on the problem of how to properly service the account. The two problems adequate service and adequate fees should be regarded as inseparable.

The accountant would do well to keep in mind the task of a salesman. It would be very easy to sell if the salesman could cut the price of his product and modify the terms of sale to meet the demands of each customer. The would-be salesman who embarks on that easy road is doomed before he starts. The successful salesman knows that he must not only make the sale but that same be at the established terms and price.

The Practical Man vs. the Idealist

In many walks of life—professional, commercial and others—one often hears the expression: "Oh, he is very impractical, just an idealist or a theorist," implying that the subject is a type unsuited for his assumed or assigned duties. On the other hand, there are characterizations of the so-called "practical" man in terms such as "impulsive," "intolerant," "impatient," "not a deep thinker," etc. The fact is that all of these accusations and insinuations may be correct, in part, in individual instances but the references do not necessarily describe the "whole" man but rather the part most obvious to the viewer.

It is not likely that anyone could be truly successful if he were only practical or if he were only a theorist. Each must have some elements of the other to be a well-rounded, mature type. A past president of Harvard University, A. Lawrence Lowell, in the preface to his book, "Conflicts of Principle" has the following to say on this subject:

"People often call some men idealists and others practical folk, as if mankind were by natural inclination so divided into these two groups that an idealist cannot be practical, or a man of affairs have a lofty purpose; whereas, in fact, no man approaches perfection who does not combine both qualities in a high degree. Without either he is defective in spirit and unscientific in method: the idealist because he does not strive to make his theory accurate, that is consonant with the facts; the so-called practical man if he acts upon the impulse of the occasion without the guidance of an enduring principle of guidance. Hence both often lack true wisdom, the idealist more culpably for he should be diligent in thought and seek all the light he can obtain. It is useful to repeat that many men have light enough to be visionary, but only he who clearly sees can behold a vision."

Payroll Tax Notes

Conducted by SAMUEL S. RESS

New York Withholding Tax Deductions

The New York State Legislature has approved Budget Bill, Assembly Introductory No. 2306, Senate Introductory No. 1731, to amend the tax law, in relation to the rates, exemptions, withholding and payment of taxes upon and with respect to personal incomes. Under this measure, which becomes operative on and after April 1, 1959, a new Section 366 of the Tax Law was enacted. It provides for the collection of tax on wages at the source of payment thereof. It also provides for the filing of certain information reports. Here are some of the significant provisions of the new law with respect to the withholding features.

1. On and after April 1, 1959, every employer making payment of any wages taxable for personal income tax by the State of New York "shall deduct and withhold upon such wages for each payroll period, a tax computed in such manner as to result, so far as practicable, with due regard to the exemptions allowable under Section 362 . . ., in withholding from the employee's wages during each calendar year, a sum which is substantially equivalent to the amount of tax reasonably estimated to be due . . . resulting from the inclusion in the gross income of the employee of his wages received during such calendar year. The method of determining the amount to be withheld shall be prescribed by regulations of the tax commission." (Section 366.1 of the Tax Law.)

On March 12, 1959, the State Tax Commission, pursuant to the aforesaid power granted to it, had published the new withholding tax tables that employers are advised to use in making this new state tax deduction.

Copies of the New York State withholding table have been prepared for employers with weekly and monthly payrolls, as well as for various other payroll periods. These tables may be obtained by writing to the New York State Tax Commission, Governor Alfred E. Smith Building, Albany 1, New York.

2. On or before the start of employment, or during the month of April 1959, employed persons are required to furnish employers with signed withholding exemption certificates in a form to be prescribed by the State Tax Commission. It is expected that these forms may become available during the month of April 1959. However, since the state tax deductions start April 1, 1959, it would appear advisable that the withholding exemption certificates presently being used by employers for federal withholding tax could be used for New York State tax purposes as well, until

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Dr. Ress is a member of the Society's Committee on New York State Taxation and chairman of its Subcommittee on Unemployment Insurance.

such time as the new state forms become available. The exemptions claimed by an individual may not exceed the number of exemptions to which he is entitled under Section 362 of the Tax Law which sets forth the amounts of exemption for the taxpayer and for each of his dependents as therein defined. The definition follows closely the definition of dependents as set forth in the Internal Revenue Code, and provides for additional exemptions for taxpayers or their spouses who may be blind or over age 65 before the close of the taxable year. Provision is also made for exemption certificate changes during the course of the year, similar to the present provisions in the Internal Revenue Code.

3. Employers are required to furnish employees from whom state withholding taxes were collected, with a yearly statement of the amount of wages paid by the employer to the employee, the amount withheld for New York State income tax, and such other information as the State Tax Commission may require. These statements must be furnished on or before February 15th of the succeeding year or, if the employment is terminated sooner, on the date on which the last payment of remuneration is made. It may be advisable, until new forms are available, to use forms similar to the present state non-resident withholding tax forms.

4. Every employer required to deduct and withhold any tax for the calendar quarter starting April 1, 1959, and for each calendar quarter thereafter, on or before the last day of the month following the close of the calendar quarter must file a withholding tax return in a form prescribed by the State Tax Commission, and pay over to the tax commission the taxes so required to be deducted and withheld. Where the aggregate amount deducted and withheld by any employer is less than $25 in a calendar quarter and the aggregate for the calendar year can reasonably be expected to be less than $100, the tax commission by regulation may permit an employer to file and pay on an annual basis. The tax commission may, if it believes that such action is necessary, require any employer to make such return and pay to it the tax deducted and withheld at any time, or from time to time.

5. Any amount of tax actually deducted and withheld under the law, shall be held to be as a fund in trust for the tax commission. Every employer required to deduct and withhold any tax is made liable for such tax just as if the tax were the employer's own tax obligation. The employer is also liable for penalties and interest on the tax which may be assessed against the employer should the employer omit to deduct and withhold the required tax from the employees' wages.

6. A non-resident employee of a New York employer is permitted to file a certificate with the employer exempting such employee's wages from the New York State withholding tax provided that the State of New York and the state in which the non-resident employee resides have entered into a reciprocal arrangement granting appropriate credits.

7. Annual information returns are required for the reporting of fixed or determinable payments (e.g., rents, annuities, etc.) amounting to $600 or more a year. These returns must be filed on or before February 15th of the year following. A copy of the statement furnished to an individual employee showing the amount of the employee's earnings and the New York State income tax withheld may serve as the required information return in the case of wage payments.

Federal Income Taxation

Decisions and Rulings — RICHARD S. HELSTEIN, CPA

Commentary — Committee on Federal Taxation
Chairman, HERBERT M. MANDELL, CPA

Decisions and Rulings

Welfare and Pension Plans Disclosure Act

Congress has enacted a new "Welfare and Pension Plans Disclosure Act," effective January 1, 1959. The purpose of the Act is to protect the interests of participants and their beneficiaries in welfare and pension plans. To accomplish this, the Act imposes the duties of disclosure and annual reporting upon administrators of certain plans established or maintained by employers, by employee organizations, or jointly by both.

The Act requires that an initial report, setting forth a description of the plan, be filed by the administrator of any plan which is subject to the Act. If the plan was in existence prior to January 1, 1959, this initial report must be filed by April 1, 1959. The United States Department of Labor recently issued forms to be used for this purpose.

The Act applies to welfare or pension plans established or maintained by employers who are engaged in interstate commerce, or whose activities affect interstate commerce, provided that the plan covers more than twenty-five employees. A welfare plan is defined as a plan for the benefit of participants or their beneficiaries, through the purchase of insurance or otherwise, which provides for medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death, or unemployment. A pension plan is a plan for the benefit of participants or their beneficiaries, by the purchase of insurance or annuity contracts or otherwise, which provides for retirement benefits, including profit-sharing plans. In either case, the plan must be one which is communicated to the employees, or the benefits thereunder described in writing to the employees.

If the Act is applicable, the administrator is required to publish a description of the plan and also an annual financial report. The administrator is the person or persons designated by the terms of a plan or a collective bargaining agreement to control the funds, even though such control is exercised through an agent or a trustee designated by such person or persons. This definition of

the term "administrator" raises a question with regard to who will be considered to be in control of the funds of a group life insurance plan. Apparently, life insurance companies are taking the position that they are not the administrators. Pending further clarification by the Secretary of Labor, the answer to this question remains in doubt, although it is probable that the employer will be held to be the administrator.

The requirements call for (1) filing the description of the plan and the annual reports with the Secretary of Labor on forms to be provided by the latter for this purpose, and (2) making copies of the description and the annual reports available to any participant or beneficiary. Failure to file the required reports with the Secretary of Labor is subject to fine or imprisonment. Failure or refusal to make the required information available to a participant or beneficiary may cause the administrator to be liable to any such participant or beneficiary in the amount of $50 a day from the date of such failure or refusal.

The description of the plan must be signed and sworn to by the administrator. The annual report, consisting of a statement of assets and liabilities and a detailed statement of operations, may be sworn to by the administrator or certified to by a certified public accountant. The description of the plan must be filed within 90 days after January 1, 1959, or within 90 days after the date on which the plan is established, whichever is later. Annual reports must be filed within 120 days after the end of the calendar year or within 120 days of the fiscal or policy year depending upon the basis used in keeping records of the plan.

RICHARD S. HELSTEIN, CPA, *has been a member of our Society since 1940. He is a member of the Committee on Federal Taxation and of the Committee on Publications. Mr. Helstein is associated with J. K. Lasser & Co.*

Gifts to Employees

The Internal Revenue Service has ruled that gifts distributed to employees by their employer, such as turkeys, hams "or other merchandise of similar nominal value" constitute excludable gifts to the employees, and their cost is deductible by the employer as a business expense under Section 162, IRC 1954 (Rev. Rul. 59-58). However, it should be noted that:

1. This does not apply to cash gifts, gift certificates and similar items of readily convertible cash value *regardless of the amount involved.* Such gifts are reportable income by the employee subject to withholding.

2. There is no indication that "nominal value" varies commensurate with the position of the employee. Thus, if employees generally are receiving turkeys, it is probable that the executives will be limited to merchandise of simi lar value.

3. The gift must be to employees of the taxpayer. Gifts to employees of customers or suppliers are not covered by this ruling.

4. It would seem that the gift must arise because of an occasion such as a holiday. Thus, gifts awarded as incentive prizes would not be covered by the ruling.

Income or Bequest?

The taxpayer entered into a contract whereby she would perform certain services for an individual during his lifetime, the consideration for which

was to be one-fifth of his estate. The employer died intestate four and one-half years later, and the taxpayer instituted suit. After years of litigation, she was finally awarded $120,000. The attorney's fees incurred were approximately $50,000.

The Commissioner was upheld by the Tax Court in treating the $120,000 as taxable income, and, in accordance with Section 107, IRC 1939 (similar with respect to the facts in this case to Section 1301, IRC 1954), apportioned that sum over the four and one-half years that the taxpayer rendered services to the decedent. The attorney's fees, however, were not so apportioned, but were treated as a deduction in their entirety in the year in which they were paid.

The taxpayer appealed, contending that the $120,000 was not taxable income since it was a bequest (see Sections 22(b)(3), IRC 1939 and 102(a), IRC 1954). In the alternative, the taxpayer claimed that the attorney's fees should be applied in reduction of the taxable income, and, in effect, spread over the same four and one-half years.

The Fifth Circuit denied the taxpayer's first point of appeal pointing out that she was not a beneficiary of the estate but a creditor, since here the "only remedy was by an action on the contract." It said: "The relief available depends upon principles of contract law and the fact that the consideration moving from the promisor was the making of a will does not distinguish it from any other contract where a promisee has to do something or give something."

However the Court held that under the law of the state involved, the $50,000 never belonged to the taxpayer, but belonged to the attorney, and therefore could not be income to the taxpayer. As a result, only the $70,000 was taxed to her under Section 107. (*Ethel West Cotnam* v. *Com.* CA-5. 1/23/59.)

Depreciation

The decision of the District Court of Delaware that the Commissioner's interpretation of "useful life" in computing depreciation as set forth in Regulations Section 1.167(a)-1(b) enacted June 11, 1956 was not retroactive (see *Hertz Corp.* v. *U. S.* discussed at p. 755 of the October 1958 NYCPA) has been buttressed by a decision of the 9th Circuit Court of Appeals. Holding that administrative practice and judicial interpretation had always in the past regarded "useful life" as the physical, economic or functional life of the property subject to depreciation, as opposed to the new concept of limiting "useful life" to the period during which the property may be useful to the taxpayer in the production of income in *his particular trade or business*, the 9th Circuit reversed the Tax Court and held that the concepts extant in the years involved (in this case, 1950 and 1951) were to be applied.

The depreciable property involved in the instant case was again automobiles acquired and held for rental to the public. The taxpayer depreciated the automobiles over a four-year life, with no salvage value at the end of the four-year period. The Court held that there was salvage value, and that this salvage value was not scrap value but should be measured by the reasonable expectation of the sale value at the end of the useful life of the asset, and should be taken into account in computing depreciation.

Finally, the Court held that since the automobiles were property used in the taxpayer's trade or business, not held

primarily for sale to customers, they constituted Section 117(j) assets (Section 1231 assets under the 1954 Code) despite the effect upon the revenue in situations of this kind. (*Robley H. Evans et al* v. *Com.*, CA-9, 1/26/59.)

Commentary

Reimbursed Expenses Where Individual Has Two Employers

Suppose an individual works for both Company *X* and Company *Y* during a taxable year. Company *X* reimburses him for all his business expenses and requires an accounting. Company *Y* does not reimburse him for his business expenses. If the individual wants to claim a deduction for his unreimbursed expenses (all of which pertained to his employment by Company *Y*), must he show in his return the amounts received from Company *X* as reimbursement?

Regulations Section 1.162-17(b)(3) states that "If the employee's ordinary and necessary business expenses exceed the total of the amounts charged directly or indirectly *to the employer* . . . [and] he wishes to secure a deduction for such excess, he must submit a statement showing . . . the total of any charges paid or borne *by the employer* and of any other amounts received *from the employer*." (Emphasis added.) This would seem to mean that the employee could claim a deduction for unreimbursed expenses of Company *Y* and not be required to submit the statement of reimbursed expenses of Company *X* providing, of course, he does not claim any excess expenses with respect to his employment with Company *X*.

It appears that this problem was not considered when the regulations were promulgated. It is therefore possible that the Commissioner may issue a further ruling requiring the complete listing in such a situation.

Buy-Sell Agreement and Decedents' Estates

Stock-purchase agreements, dated prior to 1954, wherein a corporation obligates itself to purchase the shares of a deceased stockholder, should be reviewed in order to ascertain whether the purchase or redemption does not run afoul of Sections 302 and 318 of the Code.

Section 302 provides that redemptions of stock are to be treated as dividends unless the redemption terminates the shareholder's interest in the corporation, is substantially disproportionate with respect to the shareholder whose stock is redeemed, or is not essentially equivalent to a dividend. In determining whether there has been a complete termination of an interest, or a substantially disproportionate redemption, the constructive ownership rules of Section 318 come into play. This section, in effect, states that stock owned by an estate is declared to be owned proportionately by the beneficiaries and, conversely, stock owned by the beneficiaries is declared to be owned by the estate. The regulations provide that a person is not considered a beneficiary of an estate unless he has a direct present interest in principal or income. This would exclude a remainderman after a life estate from the operations of this rule.

A recent revenue ruling (Rev. Rul. 56-103, 1 CB 159, 1956) has explained the mechanics of these provisions. A corporation's stock was owned 27 percent by an estate, 48 percent by de-

cedent's son and 25 percent by employees. The sole beneficiary of the estate was decedent's son. A stockholder's agreement was in existence which obligated the corporation to buy from decedent's estate as many shares of stock as $75,000 would buy at book value. Accordingly, the corporation redeemed 13 percent of decedent's stock for $75,000 and, in addition, redeemed the balance of the 14 percent.

It was held that decedent's estate is considered to own all the stock owned by the sole beneficiary of the estate. Therefore, the estate owned the son's 48 percent and its own 27 percent for a total of 75 percent. Hence, the redemption of 27 percent did not qualify as a termination of a shareholder's interest or as a substantially disproportionate redemption. Accordingly, the redemption constituted a distribution essentially equivalent to a dividend, except to the extent the distribution may qualify under Section 303. This section allows a corporation, under certain circumstances, to purchase the stock of a decedent in order to pay estate taxes and administrative expenses.

The foregoing rules apply even where there is no plan of tax avoidance. The existence of a prior written agreement between the corporation and decedent is without significance.

COMMITTEE ON FEDERAL TAXATION

HERBERT M. MANDELL, CPA, Chairman, *Clarence Rainess & Co.*
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Payroll Taxes In Connection with Construction Must be Capitalized

A taxpayer is granted an election under Section 266 to capitalize certain taxes and carrying charges incurred in connection with the construction of property in accordance with regulations prescribed by the Secretary or his delegate. The final regulations state that this section allows the capitalization of taxes which would otherwise be deductible under Section 164, which specifically defines those taxes that are deductible. Payroll taxes are not covered by Section 164 so that these taxes are deductible under the general trade or business expense deduction of Section 162. When payroll taxes are incurred in connection with the construction or acquisition of capital assets they are therefore not subject to the election under Section 266.

Section 24(a)(7) of the 1939 Code (the counterpart of Section 266) and regulations issued thereunder apparently permitted federal social security taxes to be deducted, as taxes, when they were incurred in connection with the construction of property. (See examples (2), (3), and (4) under Regulation 118, Section 39.24(a)-(6)(b)(4).) This rule remained undisturbed from 1942 (the date the section was originally enacted) to the issuance of final regulations under Section 266 of the 1954 Code. The *proposed* regulations under Section 266 had also supported the deduction.

The final regulations under Section 266, however, make it clear that payroll taxes are not subject to the election under Section 266 and must be capitalized without regard to that section. (See Regulations 1.266-1(b)(2) and example (4) of Regulations 1.266(d).)

This is a complete reversal of the position of the Internal Revenue Service. When queried on this matter, Chief Counsel's office stated that in their opinion the final regulations under Section 266 requiring the capitalizing of social security taxes are correct. They maintain that Regulations 111 and 118 have been incorrect since passage of the 1943 Act. That Act made social security taxes deductible (if at all) as trade or business expenses (1954 Code Section 162), rather than as taxes.

Treatment of Unused Foreign Tax Credit

A member of our Society has raised the question as to whether or not Section 904(c), which was added to the Code by the 1958 Revenue Act, permitting the carryover and carryback of unused foreign tax credits, applies in the case of a net operating loss in a particular year.

The 1958 provision allows a two-year carryback and a five-year carryover of unused foreign tax credit disallowed under the limitation of Section 904(a). This carryover or carryback is effective for taxable years beginning after December 31, 1957.

The Committee report indicates that the purpose of the new provision is to eliminate double taxation which could occur if the provision were not enacted. While the illustrative situations, mentioned in the Committee report, do not cover the case of a net operating loss, the Internal Revenue Service in Washington has informally indicated that the regulations will probably have a broader application than may have been originally intended, and thus carryover and carryback provisions with respect to unused foreign tax credit will be permitted where the credit cannot be used because of a net operating loss.

Capital Gains of Short-Term Trusts

Much has been written about the advantages of the 10-year reversionary trust. Such a trust is a very effective means of transferring income from a high-bracket taxpayer to one paying lower taxes, while allowing the grantor to regain his principal at the end of the trust term.

In recommending such a trust, the problem of capital gains should not be overlooked. Ordinarily, capital gains are added to the corpus of the trust. If this is done, the gains are taxable to the grantor in the year in which they occur, because they are considered as income being held for future distribution to him. (Regulations Section 1.677(a)-1(f) and (g), example (2).)

The taxation of such gains to the grantor may be avoided by providing in the trust instrument that they are to be included in the income going to the income beneficiary. If the income is currently distributable, the capital gains will be taxed to the beneficiary. If the trust income is to be accumulated for later distribution to the beneficiary, all of the income, including the capital gains, is taxed to the trust.

Another approach is to provide that the current income is to go to one beneficiary and the capital gains to another, either currently or at the end of the trust term. For example, Mr. Smith could set up a trust for 10 years and provide for the regular income to be distributed to his mother currently, and the capital gains to be held for distribution to his wife at the end of the term. The gains would be taxable to the trust. They could, of course, be made currently distributable to his wife, in which event they would be taxable to her in the year realized by the trust. However, it might be advantageous to have the gains accumulated and taxed

to the trust in a lower bracket than that of the Smiths. Even the long-term gains could be taxed to the trust at a starting rate of 10 percent (the lowest bracket on one-half of the gains). If the gains are to be held in the trust, the computation of the net amount accumulated for the beneficiary must be made on an annual basis. If one year's gains may be used to offset another year's losses, the Internal Revenue Service would probably take the position that the gains might return to the grantor and are, therefore, taxable to him.

What are the gift tax effects of a provision that capital gains are not to be included in the trust principal which returns to the grantor? The gift tax regulations set forth a table which gives the percentages to be applied to the trust corpus in order to determine the value of a gift of income. Neither the regulations nor any cases shed any light on the question of whether or not the percentage changes if the grantor also disposes of *potential* capital gains. It would seem that the latter gift occurs in the years of the creation of the trust, just as does the gift of current income. It is difficult to find a theory for a gift in a later year (e. g., the year of termination) if the grantor is not the trustee and has given up control of the corpus in the year the trust is created.

The answer may be in Gift Tax Regulations Section 25.2512-5(a)(1) which provides that: "Where the donor transfers property in trust or otherwise and retains an interest therein, the value of the gift is the value of the property transferred less the value of the donor's retained interest." If the corpus to be set up in trust has appreciated over basis to the grantor, and if any gains resulting from the realization of such appreciation would not revert to the grantor, the Service might very well say that the value of the retained interest does not include such amount because it *might* not return to the grantor.

On the other hand, if the corpus had not appreciated over basis when the trust is created, or if there is an appreciation over basis and such appreciation would not be accumulated for or distributed to a beneficiary, the retained interest should be based upon the full value of the original corpus. If this theory is correct, there should be no gift tax on the beneficiary's capital gains. For income tax purposes, these gains would be measured from the value of the assets on the date the trust was created. Of course, under these circumstances, the gains resulting from the appreciation over basis up to the date the trust was created would be taxable to the grantor when realized by the trust.

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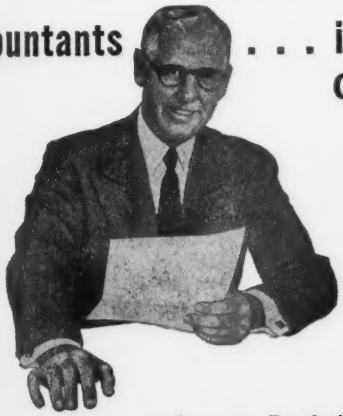
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